The Center for Law and Economic Studies – Columbia University School of Law

Columbia Law and Economics Working Paper No. 363

European Corporate Governance Institute

Law Working Paper No. 144/2010

Dispersed Ownership: the Theories, the Evidence, and the Enduring Tension Between 'Lumpers' and 'Splitters'

John C. Coffee Jr.

Columbia Law School, American Academy of Arts & Sciences and ECGI

Dispersed Ownership: The Theories, the Evidence, and the Enduring Tension Between 'Lumpers' and 'Splitters'

Law Working Paper N°. 144/2010
February 2010

John C. Coffee Jr.
Columbia Law School, American Academy of Arts & Sciences and ECGI

ECGI Working Paper Series in Law

Dispersed Ownership: The Theories, the Evidence, and the Enduring Tension Between 'Lumpers' and 'Splitters'

Working Paper N°.144/2010

February 2010

John C. Coffee Jr.

Abstract

From a global perspective, the single most noticeable fact about corporate governance is the radical dichotomy between dispersed ownership and concentrated ownerships systems, with the latter being much in the majority. Several prominent academics have offered grand theories to explain when dispersed share ownership arises, which have emphasized either legal or political preconditions. Nonetheless, mounting evidence suggests that these theories are overgeneralized and, in particular, do not account for the appearance (to varying degrees) of dispersed ownership in all securities markets. This article concludes that neither legal rules nor political conditions can adequately explain the spread of dispersed ownership across both the U.S. and the U.K., which developments occurred at different times, in different political and legal environments, and were precipitated by different exogenous factors. Instead, this article offers an alternative and simpler explanation: dispersed ownership arises principally from private ordering, with legal rules playing a minor role at best. Intermediaries - investment bankers, stock exchanges, and others - fill the void created by legal shortcomings and create bonding mechanisms that allow dispersed ownership to spread beyond the limited geographic area in which the founding entrepreneur is known and trusted. This process has two steps: (1) the appearance of numerous minority shareholders, gradually spreading across a broad geographic area, and (2) the break-up of controlling blocks. At the latter stage, historical contingencies have played a major role. In the United States, the merger boom of the 1890s played a critical role, and in the U.K. punitive tax changes compelled controlling shareholders to sell. The only common denominators across the two countries were: (1) political changes followed once share ownership dispersion was achieved, as law followed the market; and (2) private ordering and self-regulation encouraged minority owners to invest and protected their voting and control rights. This may suggest that in decentralized political economies (in which political and economic power tend to be separated and in which self-regulation is more common, such as the U.S. and the U.K.), dispersed ownership is more likely to arise, but it can arise for individual firms through private ordering in any market.

Keywords: Bonding, concentrated ownership, corporate governance, dispersed ownership, institutional investor, investment bankers, liquidity/control tradeoff, merger wave, self-regulation, stock exchanges

JEL Classifications: G30, K20, K22, N21, N22, N24, P2

John C. Coffee Jr.
Columbia Law School, American Academy of Arts & Sciences and ECGI
435 West 116th Street
New York, NY 10027
United States
phone: 212-854-2833, fax: 212-854-7946
e-mail: jcoffee@law.columbia.edu

DISPERSED OWNERSHIP:
The Theories, The Evidence, and the Enduring Tension Between
"Lumpers" and "Splitters"

by John C. Coffee, Jr.*

Table of Contents

* Professor Coffee is the Adolf A. Berle Professor of Law at Columbia University Law School and Director of its Center on Corporate Governance.

<u>Introduction</u>

From a global perspective, the most salient fact about corporate governance is its seemingly binary character. At least at first glance, the world divides neatly into two categories: (1) "concentrated ownership" systems, and (2) "dispersed ownership" systems, with the former being far more common. In the former system, a controlling shareholder, a family group, or a small number of blockholders holds either majority or de facto control and places their representatives on the controlled firm's board of directors.[1] In the latter system, there is instead a "separation of ownership and control" with neither the directors nor the senior executives typically holding significant blocks of the company's stock and with share ownership instead being dispersed among many institutional and retail shareholders.[2] Defining elements of this latter system also include (1) an independent board, whose members will typically have no business relationships with the corporation, and (2) relative investor passivity, at least to the extent that highly diversified institutional investors do not seek to actively manage the business or participate in most managerial decisions.

Much hangs on this difference in the structure of share ownership, as the nature of the agency costs faced by shareholders depends upon ownership structure. In the

---

[1] Marco Becht and Colin Mayer found that, as of 2001, in the majority of European companies a single voting block held a majority of the voting shares, whereas in the U.S. and the U.K., the corresponding figure was less than 3%. See Marco Becht and Colin Mayer, "Introduction" in Fabrizio Barca and Marco Becht (eds.), THE CONTROL OF CORPORATE EUROPE (2001).

[2] This is, of course, a one sentence summary of the Berle/Means thesis, which announced that a "separation of ownership and control" had left professional managers running U.S. public corporations. See Adolf A. Berle and Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). Debate still continues as to the accuracy of the Berle/Means thesis, with some maintaining that the separation is less complete or prevalent than those authors claimed. For a thorough review of this debate and a guarded re-affirmation of the Berle/Means thesis, see Brian Cheffin and Steven Bank, "Is Berle and Means Really a Myth?," ECGI Law Working Paper No. 121 (2009), (available at http://ssrn.com/abstract=1352605). It is, of course, true that many U.S. and U.K. firms do have controlling shareholders.

dispersed ownership structure, managers have broad discretion, can act opportunistically, and need to be monitored and constrained by an independent board. In the concentrated ownership structure, the focus of monitoring shifts from the manager to the controlling shareholder.[3] Moreover, the prospect of a truly independent board is less likely when ownership is concentrated, and thus alternative protections that do not depend upon board oversight must be found.

Commentators commonly refer to the dispersed ownership structure as the "Anglo-Saxon model" of corporate governance, because only in two "Anglo-Saxon" countries – the United States and the United Kingdom – does the structure of share ownership appear to conform relatively closely to the foregoing profile of "dispersed ownership" systems.[4] Elsewhere, concentrated ownership tends to predominate (with a few countries falling between these two poles and with Canada actually having evolved to dispersed ownership only to regress back to family-controlled concentrated ownership[5]).

Still, this binary perspective oversimplifies. Although the contrast between "dispersed" and "concentrated" ownership as divergent systems of corporate governance is basically accurate, this dichotomy can mislead in at least two respects:

---

[3] For an overview of these differences in agency costs, see John C. Coffee, Jr., A Theory of Corporate Scandals: Why the U.S. and Europe Differ, 21 Oxford Review of Economic Policy 198-211 (2005). How closely the U.S. and the U.K. conform to the Berle/Means or Anglo-American model remains open to debate. See Cheffins and Bank, supra note 2.

[4] Debates have long continued over the relative superiority of the "Anglo-Saxon Model" vs. European or concentrated ownership models of corporate governance. For a review of the empirical evidence, see Klaus Gugler and Dennis Mueller, Corporate Governance and the Returns on Investment, 47 J. Law & Econ. 589 (2004). For a strong assertion of the superiority of the European model over the Anglo-Saxon model, see Michel Albert, CAPITALISM vs. CAPITALISM at 160-190 (1993).

[5] See Randall K. Morck, Michael Perry, Gloria Y. Tian, and Bernard Yeung, "The Rise and Fall of the Widely Held Firm: A History of Corporate Ownership in Canada," in Randall K. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD (2005) at 65-148.

First, its implicit message of Anglo-American exceptionalism is highly questionable. The assumption that something about the common heritage of the "Anglo-Saxon" countries – their common law, politics, cultural heritage, or whatever – explains their unique convergence on a "dispersed ownership" system of corporate governance simply does not hold up under closer analysis. After all, Australia and Canada have origins at least as "Anglo-Saxon" as the United States, probably deriving their law to an even greater degree from British sources, but in these countries concentrated ownership is more common than dispersed ownership. Curiously, the nation with the next highest level of dispersed ownership to the U.S. and the U.K. is probably Japan, hardly an Anglo-Saxon country, but one where a former network of cross-ownership among firms in the same corporate group has become increasingly attenuated, resulting in a high level of ownership dispersion.[6]

Second, an even more fundamental problem with attempts to attribute dispersed ownership to a particular set of legal or political circumstances is that companies with dispersed ownership are present in virtually all developed economies.[7] Although concentrated ownership clearly predominates in most of the world, individual firms with

---

[6] Japan has recently experienced "steep declines in cross-shareholding and stable shareholding," and the shareholdings of Japanese commercial banks in Japanese public corporations fell from 16% in 1992 to 6% in 2004. See Curtis Milhaupt, In the Shadow of Delaware: The Rise of Hostile Takeovers in Japan, 105 Colum. L. Rev. 2171, 2184-85 (2005). Offsetting this decline has been an increase in the ownership in Japanese corporations held by foreign investors, most of whom are activist institutional investors. Id. at 2185-86.

[7] See Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Schleifer, Corporate Ownership Around the World, 54 J. Fin. 471-517 (1999) (surveying shareholder ownership structure in the 27 most developed countries). Using a definition of control under which a 20% shareholder is deemed to hold control, they find only two countries (Argentina and Mexico) among the 27 countries surveyed in which none of the 20 largest corporations in that jurisdiction was "widely held." Id. at 492 (Table II, Panel A). Using the lower threshold of 10% to define control, they find that three more countries join this short list (Belgium, Portugal and Sweden). Id. at 493 (Table II, Panel B). Otherwise, twenty-two out of these 27 largest economies had some "widely held" public corporations among their twenty largest companies (ranked by market capitalization).

broadly dispersed ownership can be identified in all major securities markets. Thus, although some commentators argue that dispersed ownership survives only in the presence of strong legal protection for minority shareholders,[8] the actual data that they present undercuts this claim. Specifically, LaPorta, Lopez-de-Silanes and Schleifer find that even in countries with "poor" shareholder protection, "widely held" large firms still constitute 27% of the large firms in their sample.[9] Even when one shifts one's focus from large firms to "medium-sized firms," the global percentage of "widely held" firms among "medium-sized firms" falls only to 24%, and, most surprisingly, in countries with "poor" shareholder protection, such "widely held" firms still account for 13% of all "medium sized" firms.[10] In short, the difference is relative, not absolute. Even if firms with dispersed ownership are a modest minority in many countries, such firms persist in nearly all markets, regardless of the prevailing legal rules.

In turn, this fact that a minority of dispersed ownership firms co-exists with a majority of concentrated ownership firms in most securities markets confounds attempts to explain dispersed ownership as a function of any single variable. Apparently, dispersed ownership can survive even in an inhospitable legal climate. More generally, dispersed ownership appears to be neither the winner or loser in a Darwinian evolution toward the most competitive business form, because both dispersed and concentrated ownership seem to be persisting at relatively stable levels. Ultimately, there may some day come an "end to history" with one system dominating the other, but for the present the contest remains undecided.

---

[8] This is the essential position taken by LaPorta, Lopez-de-Silanes and Schleifer.
[9] LaPorta, Lopez-de-Silanes and Schleifer, supra note 7, at 496.
[10] Id. at 497.

Predictably, the sharp dichotomy between dispersed ownership and concentrated ownership systems has attracted the attention of theorists who have sought to explain contemporary patterns of share ownership by identifying an underlying cause or variable that explains the evolution towards dispersed ownership in some countries and its relative absence elsewhere. "Lumpers" rather than "splitters" in this article's terminology,[11] these theorists – some stressing law; some, politics – have shared a strong assumption of path dependency: namely, that business firms necessarily evolved in one direction because other alternative trajectories were foreclosed.

This article disagrees, arguing instead that the evidence is more consistent with a simpler alternative explanation: dispersed ownership resulted less from inexorable forces and more from private ordering. Neither legal nor political conditions mandated or prevented the appearance of dispersed ownership. Rather, entrepreneurs, investment bankers, and investors – all seeking to maximize value – sometimes saw reasons why selling control into the public market would maximize value for them. But when and why? That is this article's focus. It will argue that law played less of a role than specialized intermediaries – investment banks, securities exchanges, and other agents – who found it to be in their self-interest to foster dispersed ownership and who compensated for weak legal protections. Initially, relying on reputational capital, self-regulatory institutions and contractual mechanisms, entrepreneurs found ways to assure

[11] In academic parlance, "lumpers" are those who seek broad gestalt-like patterns, and emphasize similarities, rather than differences. Splitters tend in turn both to focus on differences and to emphasize institutional detail. Lumpers may also be thought of as meta-level theorists who operate at a high level of generality and abstraction, while splitters tend to function at a lower level of altitude and to concentrate on specific legal or institutional detail. Splitters accuse lumpers of overgeneralization, and lumpers retort that splitters focus on differences without distinctions. No suggestion is here intended that one is usually right and the other usually wrong. But the dialogue betweent the two sides is essential.

investors that they would not be exploited if they invested in their companies as minority shareholders. This resulted in a localized dispersion of ownership with control remaining with the founder/entrepreneur. Private ordering, not mandatory legal rules, facilitated this process of trust formation. Later, partly as the result of exogenous changes involving the tax and antitrust laws in the U.S. and U.K., founders (or their heirs) did pass control to public shareholders. Again, investment bankers and stock exchanges facilitated this transition. Only once this passage occurred and dispersed ownership had taken root in a jurisdiction, did a new political constituency of minority shareholders coalesce (usually following a stock market crash) to demand legislation, enhanced legal protections, and improved disclosure.

Under this view, law followed the market, and did not create the preconditions that explain the market's evolution towards dispersed ownership. From this perspective, some level of dispersed ownership would arise in all markets (as we do observe), but whether it predominated would depend largely on whether the firm's founders believed they could maximize their profits by selling control in the public market.

Put differently, the choice that most needs explanation is why the founders of a firm would decide to sell control into the public market, rather than either retaining control or selling it at a premium to a new incoming controlling shareholder. Of course, at an abstract level, the answer has to be that entrepreneurs anticipated a higher premium from a sale of their controlling blocks into the public market, rather than to a new controlling shareholders. But why did such sales seems more attractive in those jurisdictions (chiefly the U.S. and the U.K.) that eventually became characterized as dispersed ownership countries? Here, even a partial answer requires that attention be given to other legal developments, including the antitrust laws in the U.S. and the tax laws in the U.K., that encouraged or necessitated such sales.

Ultimately an adequate explanation of the passage of control from controlling families to public shareholders compels us to face an added complexity: public investors will not rationally pay a premium for control unless they can retain that control in their hands. The key issue then is the sustainability of control in public hands. If control can be divested from public shareholders by a new control seeker who conducts a secret "creeping" acquisition in a dispersed ownership market and pays little or no premium, then the public shareholders made a strategic misjudgment in earlier paying a premium for a controlling interest that they could not retain. Over time, they will learn not to repeat this mistake, and so control, even if briefly dispersed, will predictably reconcentrate.

Indeed, this pattern of short-lived dispersed ownership is apparent in recent corporate history. When Russia and Eastern Europe privatized in the 1990s through mass privatizations, dispersed ownership proved to be a very transient phenomenon – precisely because it could not be protected and preserved in the hands of public shareholders.[12] This experience frames the key question: what was different in the U.S. and U.K. history that enable dispersed ownership to persist? How were public shareholders able to retain control? In truth, the early U.S. experience resembled that of Russia and Eastern Europe in the 1990s.[13] But, as will be seen, private ordering and strong intermediaries mitigated

[12] See generally Simon Johnson, Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Schleifer & Robert Vishny, Tunneling, 90 Am. Econ. Rev. 22 (2002) (giving examples from Eastern Europe and Russian privatization); John C. Coffee, Jr., Privatization and Corporate Governance: The Lessons From Securities Market Failure, 25 J. Corp. L. 1 (1999).

[13] "Tunneling" is a new word, developed by economists to characterize egregious self-dealing that loots an enterprise. But it could have been easily applied to the Erie Railroad in the 19th Century, when that railroad became known as the "Scarlet Lady of Wall Street" because of rampant self-dealing by insiders. See John Steele Gordon, THE SCARLET LADY OF WALL STREET (1988).

the level of predatory opportunism in both the U.S. and the U.K. – and in the absence of strong legal protections for minority shareholders.

Against this backdrop, Part II and III will examine the emergence of dispersed ownership in both the United States and the United Kingdom. It will find roughly the same sequence of events (although occurring at different points in time) under which legal reforms followed, and did not precede, the rise of dispersed ownership. In overview, the evidence shows that:

(1) dispersed ownership arose at markedly different times in these two countries (much earlier in the United States than in the U.K.);

(2) it evolved in a markedly different fashion (with dispersed ownership preceding the appearance of institutional investors in the U.S. and following their rise in the U.K.);

(3) in the U.S., investment bankers and the New York Stock Exchange had strong incentives to encourage control sales into the public markets and played a critical role in protecting the maintenance of control in public hands;

(4) although legal rules did play some role in encouraging the transition to dispersed ownership, these legal rules had little to do with shareholder protection. Instead, in the United States, an unprecedented merger wave at the end of the 19th Century, which may have been induced in part by the passage of the Sherman Anti-Trust Act of 1890, hastened the transition toward dispersed ownership. Correspondingly, in the U.K., tax changes, enacted during and after World War II, penalized controlling shareholders and induced them to sell to institutional investors (who were relatively immune from these same tax disincentives).

The U.S. and the U.K. thus present distinctly different stories, but they share at least one common denominator: in neither country was this evolution toward dispersed ownership significantly influenced by the prior existence of strong legal rules that protected minority investors. If anything, legal rules in both countries were more part of the problem than part of the answer. Instead, intermediaries – investment banks, stock exchanges and institutional investors – engaged in extensive private ordering to facilitate the rise of dispersed ownership. Also in both countries, legal rules protecting public shareholders were eventually adopted, but only after the transition to dispersed ownership had first taken hold.

Part IV will then assess what common characteristics can be found in the U.S. and U.K. experiences. It concludes that in both, law followed the market with the result that legal changes came after, not before, the transition to dispersed ownership, as a new constituency of public shareholders lobbied for legislative change. It also hypothesizes that the absence of a strong central government intent on managing economic development distinguishes both the U.S. and U.K. experiences from that of Continental Europe; in essence, the laissez-faire policies of both governments toward issues of corporate governance gave a greater role to private ordering.

Part V will turn to a final problem: why does the "Anglo-Saxon" system of dispersed ownership persist? Why do institutional investors today not assert themselves and assume control, rather than maintain a basically passive "hands off" approach that leads them to intervene only when the incumbent management appears to have become dysfunctional? Even if there were once political and/or legal constraints in the U.S. that prevented such institutional control of large public corporations, those constraints have recently eroded with the rise of hedge funds and private equity. Today, retail share ownership has declined to roughly 25% of the stock in U.S. public corporations,[14] while institutions hold the majority. Hence, past barriers to institutional control no longer appear formidable.

This article will answer this question of why institutions do not typically seek control with a provocative assertion: institutional investors do not really want control. The logistical demands required of any institutional investor that seeks to manage actively a large portfolio of companies through collective decision-making by multiple institutions are simply unacceptably costly. As a result, institutional investors implicitly recognize a basic "liquidity/control" tradeoff that leads them to avoid active involvement in managerial decision-making, except under special circumstances.[15] In particular, two factors that are neither "legal" nor "political" in nature constrain institutional investors from exercising control: (i) the cost differential between a low-cost policy of indexed diversification and a more activist, but high-cost, policy of attempting to monitor corporate managements over a broad portfolio of investments, and (ii) the collective action problems that institutional investors face in funding interventions in corporate governance. In combination, these two factors have led most institutional investors (both in the U.S. and the U.K.) to prefer liquidity to control. It can, of course, be debated whether this preference will continue under all future market conditions and regulatory structures, but the fact that this preference has now persisted in both the U.S. and the

---

[14] See J. Choper, J. Coffee and R. Gilson, CASES AND MATERIALS ON CORPORATIONS 15 (7th ed. 2008) (showing share ownership breakdown in the U.S.).

[15] See John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor As Corporate Monitor, 91 Colum. L. Rev. 1277 (1991) (developing concept of liquidity/control tradeoff).

U.K. for at least several decades suggests that it is likely to endure – at least absent major changes in the market and regulatory environment.

I. Theories of Share Ownership Structure

When Adolf Berle and Gardiner Means announced in 1932 their discovery that ownership and control had separated,[16] scholars assumed that they knew what explained this development: family-controlled companies could not finance the growth and investment that industrialization necessitated. Dispersed ownership, it was assumed, followed from the enormous capital needs of an industrialized economy undergoing rapid technological development. Only much later did the weakness in this argument become apparent when mounting evidence began to show in the late 20th Century that German and Japanese companies were competing successfully with American corporations in basic industries, notwithstanding the fact that they operated within a concentrated ownership framework.

This recognition posed a puzzle for academics: if dispersed ownership was not inevitable, what then explained the phenomenon of dispersed ownership? The initial academic response was Mark Roe's political theory of corporate governance, most fully articulated in his 1994 book, STRONG MANAGERS, WEAK OWNERS,[17] which argued that dispersed ownership was the product (at least in the United States) of a strong populist distrust of concentrated financial power. Still, as later discussed, this theory faced major problems. Most notably, it could not explain the United Kingdom, which also had dispersed ownership but no similar history of resistance to large financial

[16] See Berle and Means, supra note 2.
[17] Mark J. Roe, STRONG MANAGERS, WEAK OWNERS: The Political Roots of American Corporate Finance (1994).

institutions or of regulatory policies that discouraged financial institutions from taking collective action to influence board decisions. Yet, as later discussed, in the U.K. as well as the U.S., institutional investors have remained largely passive.

Meanwhile, during the 1990s, the Soviet Union crumbled, and wholesale privatizations of formerly state-owned firms occurred across Eastern Europe and Russia. In the wake of rapid and often poorly designed privatizations, fraud became endemic, and ownership that was initially widely dispersed through voucher privatizations swiftly re-concentrated into the hands of a few controlling shareholders. Frustrated by the fraud and predatory behavior they had witnessed at close hand, the academics who had helped design and orchestrate Russian privatization developed a second and alternative theory to explain dispersed ownership. Dispersed ownership, they explained, was the product of strong legal rules that protected minority shareholders from exploitation by controlling shareholders. Although this theory had an empirical foundation, replete with elaborate regressions, it was the product of a particular historical moment that may have led its authors to overemphasize the role of law.

Each of these theories is examined in more detail below:

A. <u>The "Law Matters" Thesis</u>

In the wake of the privatizations in Russia and Eastern Europe in the 1990s, dispersed ownership proved to be a transient phenomenon. "Tunneling" and other predatory practices, often involving egregious self-dealing, depleted the assets and revenues of privatized firms, allowing managers and controlling shareholders to exploit minority shareholders.[18] This experience understandably led academics who had worked on privatization to reach a seemingly logical conclusion: dispersed ownership could persist only in those countries that had laws that effectively protected minority shareholders from unfair self-dealing and other forms of overreaching by dominant shareholders. If the law protected minority shareholders, they reasoned, then controlling shareholders would have less ability to exploit the private benefits of control. In turn, as the private benefits of control that could be expropriated by controlling shareholders declined, the incentive to assemble control blocks would in turn decline and existing blocks might be liquidated, thus enabling dispersed ownership to develop (or persist).

Starting from this premise that ownership concentration is a consequence of weak legal protection of minority shareholders, four financial economists – LaPorta, Lopez-de-Silanes, Shleifer and Vishny (commonly referred to as "LLS&V") – developed an extraordinarily influential (but equally controversial) model of how to measure the strength of the legal protections accorded minority shareholders. They constructed a six element "anti-director rights" index to rate the strength of legal protections accorded minority shareholders. Using this index, they found a statistically significant correlation between the "quality" of corporate law, as rated by their index, and the degree of shareholder dispersion.[19] In later work, largely this same group of authors moved beyond their initial "anti-director rights" index and constructed other indices in order to measure

[18] See sources supra at note 12.
[19] See Rafael LaPorta et. al, Legal Determinants of External Finance, 52 J. Fin. 1131 (1997); Rafael LaPorta et. al, Law and Finance, 106 J. Pol. Econ. 1113 (1998).

either the specific protections accorded shareholders against self-dealing[20] or the adequacy of the country's securities laws.[21] These later indices focused more on enforcement (both public and private), and again the authors found statistically significant correlations between their indices measuring the strength of enforcement and various measures of stock market development.[22]

LLS&V's findings have elicited a legion of critics. First, there have been penetrating methodological critiques of their work. Some have reported that LLS&V's coding was inaccurate and inconsistent and in particular that errors associated with their coding of their shareholder rights indices accounted for the strength of their results.[23] Others have criticized the highly selective quality of their indices, arguing that the few variables chosen did not serve as accurate proxies for the underlying system's legal rules.[24] In later work, the principal LLS&V authors have acknowledged the legitimacy of these criticisms.[25]

---

[20] See Simeon Djankov, Rafael LaPorta, Florenco Lopez-de-Silanes and Andrei Shleifer, The Law and Economics of Self-Dealing (2005) NBER Working Paper 11883 (hereinafter, "Law and Economics Self-Dealing").

[21] See Rafael LaPorta, Florenco Lopez-de-Silanes and Andrei Shleifer, What Works in Securities Laws?, 61 J. Fin. 1 (2006).

[22] However, in Law and Economics of Self-Dealing, only ex post private enforcement showed any statistically significant correlation with ownership dispersion. This led the authors to conclude that private enforcement worked, while public enforcement appeared not to. This conclusion has attracted much (and deserved) criticism. See Howell E. Jackson and Mark J. Roe, Public and Private Enforcement of Securities Laws: Resource-Based Evidence, (Harvard Pub. Law Working Paper No. 08-28) (http://ssrn.com/abstract=1000086) (concluding that public enforcement is at least as effective as private enforcement).

[23] See Holger Spamann, On the Insignificance and/or Endogeneity of LaPorta et. al's "Anti-Director Rights Index Under Consistent Coding (ECGI Law Working Paper No. 67/2006); Holger Spamann, "Law and Finance" Revisited (Harvard Law School John M. Olio Center Discussion Paper No. 12, 2008); Sofie Cools, The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers, 30 Del. J. Corp. L. 697 (2005).

[24] John Armour, Brian R. Cheffins & David A. Skeel, Jr., Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the U.K., 55 Vand. L. Rev. 1699-1785 (2002).

[25] See Simeon Djankov, Rafael LaPorta, Florencio Lopez-de-Silanes & Andrei Shleifer, The Law and Economics of Self-Dealing, 88 J. Fin. Econ. 430 (2008).

A second problem has been the direction of causality. Even if LLS&V's anti-director rights were in fact correlated with greater dispersed ownership, did this mean that they had produced dispersed ownership? Or could these legal rights have been instead the product of dispersed ownership, as a broad coalition of public shareholders, once formed, came to demand legislative protection that produced the legal rules picked up in LLS&V's anti-director index.[26] Although LLS&V never examined the historical origins of the legal variables on their anti-directors index, others have and found that several are of fairly recent origin, having been adopted well after dispersed ownership became the dominant structure in the U.S. and U.K.[27] In short, law may well have followed economics, with the development of dispersed ownership causing a shift in legal rules in those countries where it became prevalent.

In response to this problem of endogeneity, the LLS&V authors shifted their focus. Instead of measuring the "quality of law" by tabulating the existing or non-existence of specific legal rights, they moved in later work to a more generalized hypothesis: namely, that the quality of legal institutions varied systematically with the "origin" of a country's legal system. Here, they divided the world's legal systems into basically four categories: (1) Anglo-American common law systems, (2) French civil law systems, (3) German civil law systems; and (4) Scandinavian civil law systems. This shift appears to have been an effort to deal with the direction of causality, because these legal families predated the Industrial Revolution and the spread of the corporate form.

---

[26] For this view, see John C. Coffee, Jr., The Rise of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control, 111 Yale L. J. 1 (2001).

[27] For example, see Brian R. Cheffins, CORPORATE OWNERSHIP AND CONTROL: British Business Transformed (2008) at 358-359 (noting that the high level at which prospectus disclosure regulation in the U.K. was rated by LLS&V was the result only of a 1986 legislative change, which formalized certain pre-existing stock exchange rules). In short, the dating was arbitrary.

Given this clear timing difference, it could not be plausibly argued that either the structure of share ownership or the level of economic development had caused or influenced a country's legal origins. Legal origins were thus a truly independent variable.

Still, even if they had thus resolved the problem of causation to their own satisfaction, the attempt to use legal origins to explain economic development created even greater controversy. LLS&V reported that countries whose legal origins derived from the civil law systems (and, worst of all, French civil law systems) exhibited the lowest protections for minority shareholders; in turn, lower shareholder protection correlated with high levels of concentrated share ownership. Conversely, higher quality corporate, securities, and bankruptcy laws were found to be associated with common law systems. Because these latter jurisdictions provided higher levels of protection for minority shareholders, it was no surprise to LLS&V that corporations incorporated in those jurisdictions exhibited more dispersed share ownership, paid out greater dividends, and generally had higher share prices than firms incorporated in civil law jurisdictions.

Nonetheless, this revised "legal origins" approach was equally fraught with methodological peril. LLS&V's division of all legal systems with four categories – common law, French, German, and Scandinavian – may have worked for Europe, but outside of Europe the appropriate classification of the legal systems of countries in Asia, Africa, Latin America and even Eastern Europe remains highly debatable.[28] For example, while LLS&V deemed China and Japan to be countries of German legal origin, China's corporation law actually derives from Taiwan, France and Japan as well. In the case of Japan, although Japan borrowed much German civil law at the end of the 19th Century, its

[28] For an overview of these problems, see Mathias Siems, Reconciling Law & Finance and Comparative Law, 52 McGill L. J. 55 (2007).

corporate and securities law were taken nearly intact from the United States after World War II. Latin America is even more ambiguous, as its law was borrowed from Spanish sources that were, at most, only briefly influenced by France prior to South America's wars of independence.[29] Indeed, the strength of LLS&V's correlation between the "quality" of the common law and the superior economic development in countries with common law legal systems depends heavily on the ambiguous status of Latin America.[30] Yet, however we classify Latin America in terms of its legal origins, the possibility looms large that its relatively poor economic development may be the product of unrelated factors (poor economic endowments, a weak political tradition, a history of military dictatorship, etc.) that had little, if anything, to do with specific legal rules.[31]

A final problem is that there is evidence that some "civil law" countries did develop strong securities markets, but later reversed policies and discouraged their further growth and development.[32] This suggests that politics could trump law and that political attitudes could change abruptly. To sum up: even if U.K. and the U.S. developed stronger securities markets, the debate remains open as to whether this development was the product of politics, law, or more general factors in their social structure. Precisely

---

[29] The Napoleonic influence of French law on Latin America seems to have been short-lived, while the influence of U.S. law may have had a far longer duration. See Kenneth Dam, THE LAW-GROWTH NEXUS: The Rule of Law and Economic Development, 42-45 (2006).

[30] Id. at 42-45 (arguing that low economic growth in Latin America explains the difference between the economic performance of common law and French civil law countries and doubting that Latin America should be classified as of French civil law origin).

[31] For the views that geography and colonial endowments better explain variations in postcolonial economic growth, see Jared Diamond, GUNS, GERMS AND STEEL: The Fates of Human Societies (1997), and Daron Acemoglu et al., The Colonial Origins of Comparative Development: An Empirical Investigation, 91 Am. Econ. Rev. 1369, 1372-73 (2001).

[32] See Raghuram G. Rajan and Luigi Zingales, The Great Reversals: The Politics of Financial Development in the Twentieth Century, 69 J. Fin. Econ. 5, 14-17 (2003). This shift away from financial development could have been motivated by the desires of commercial banks to slow the development of rival institutions, or because finance ministries wanted greater control over the allocation of capital and to spur defense-related industries.

because both countries were decentralized and adopted common laissez-faire positions toward economic planning and corporate development, their governmental inaction may have fostered private law-making and robust self-regulatory institutions (such as stock exchanges).[33]

B. The "Politics Matters" Thesis

In 1994, Mark Roe announced a thesis that was provocative, iconoclastic and path-breaking: the structure of shareholder ownership in the U.S. was determined not by economic efficiency, but by political constraints.[34] Because the U.S. historically disfavored concentrated financial power, the bank-centered system of financial control of public corporations that had arisen in Europe and Japan could not develop in the United States, and so shareholder ownership stayed dispersed, rather than concentrated. The book was widely and deservedly heralded, in large part because it seemed to show that political factors could and did trump economic efficiency. In retrospect, however, his specific thesis seems much influenced by the then seeming superiority of Japanese and German corporate governance.[35] Within just years of his statement of this thesis, Japanese and German corporate governance faded in their seeming efficiency. But Roe's thesis persisted in its popularity, because it focused scholars on the political factors that might determine economic structure (and thus encouraged scores of political science graduate students to explore a range of possibilities).

[33] For a fuller development of this argument, see Coffee, supra note 26, at 59-64.
[34] See Roe, supra note 17.
[35] Professor Roe had a year earlier focused on the advantages of German and Japanese corporate governance. See Mark J. Roe, Some Differences in Corporate Structure in Germany, Japan and the United States, 102 Yale L. J. 1927 (1993).

Nonetheless, original as his thesis was, it faces some basic problems: First, the most obvious indications that the U.S. political system disfavored concentrated financial power came after the advent of the separation of ownership and control.[36] Second, simpler explanations are possible for the underdeveloped size of U.S. financial institutions. Early in his book, Roe focuses on the fragmentation of banking power in the United States, but this fragmentation does not really require a political theory to explain it. As he emphasizes, by 1900, the National Banking Act had already been interpreted to preclude multi-state banking.[37] Arguably, this could have been because of a political distaste for concentrated financial power. Or, it could more simply be attributed to the fact that banks in each state wanted to evade competition from larger, out-of-state rivals. Inherently, the United States's federal system had guaranteed state banks a local oligopoly – unless federal law permitted national banks to leapfrog over state boundaries. Banks in smaller jurisdictions naturally feared that larger banks in New York or other major cities would compete business and clients away from them if interstate banking were facilitated.

Thus, that state banks resisted legislation giving national banks such multi-state banking powers is hardly surprising. Although, from Roe's perspective, the restrictions placed on interstate banking can be viewed as an expression of hostility toward

---

[36] Roe does recognize this timing problem, but much of his book is still focused on the restrictive laws regulating banking, mutual funds, pension funds, insurers, and takeovers that were adopted during the New Deal or afterwards. The Glass-Steagall Act, separating commercial and investment banking, was enacted in 1933. The Investment Company Act of 1940 regulated mutual funds and effectively required them to be highly diversified. In Roe's view, this precluded most mutual funds from holding large blocks. See Roe, supra note 17 at 104-105. Roe analyzes the regulation of takeovers and proxy solicitations and similarly views provisions in the Securities Exchange Act of 1934 (and the Williams Act, which was largely added in 1970 to the Securities Exchange Act) as intended to protect managers from shareholder control. Id. at 151-168. All this may well be evidence of hostility to financial concentration, but it comes well after the separation of ownership and control.

[37] See Roe, supra note 17, at 54-55.

concentrated financial power, the simpler interpretation is that local banks united to lobby for the preservation of the economic rents that a fragmented federal system gave them. To use a humble analogy, if one were mugged in a city alley, this could be viewed as a political act that expressed the egalitarian values (or at least the Robin Hood-like politics) of the assailant. But the simpler view is just that the mugger wanted your money. Thus, if one accepts Occam's Razor and believes that the simpler hypothesis should be preferred, the Roe theory seems overly complicated. That is, a federal structure alone can explain fragmented banking power and may have precluded an efficient consolidation of financial firms – all without any need for resort to a political theory such as Roe offered.

A good case can also be made that, as of 1900, the largest, most powerful financial institutions in the United States did not want the combined ownership and control of industrial America. Rather than owning industrial companies, J.P. Morgan & Co., the dominant financial institution of the era, found it more profitable (as later described) to serve these companies and their shareholders as their financial advisor and underwriter. It was able during this period to exercise a degree of control without any ownership by quietly serving on the boards of these firms, and it profited greatly in so doing. But it (and similar firms) refused to grow into European-style universal banks; for example, they refused to hold large blocks of securities or to accept bank deposits from all but special clients.[38] Such investments carried risks, and taking retail deposits required a large staff. Over time, the banks that took retail deposits did supercede Morgan and its

[38] As a wholesale and privately held bank, J.P. Morgan & Co. had neither public customers nor public shareholders. It would only accept deposits from the large corporations that it served. See Ron Chernow, THE HOUSE OF MORGAN: An American Banking Dynasty and the Rise of Modern Finance, (1990) at 256. It first sold stock to the public in 1942. In opting to remain private, it allowed itself to be superceded in size by those banks that did take retail deposits. Id. at 304. But this was its voluntary decision, not the result of legal rules.

peers in size and scale, but J.P. Morgan & Co. and its fellow aristocrats opted for a leaner business model and may have profited more handsomely from their decision. Conversely, those financial institutions that wanted to expand found it possible to escape the restrictions on multi-state banking by forming separate securities affiliates, which several operated on a coast to coast basis.[39] The case then has not been dispositively made that the restrictions on concentrated financial power were truly binding and could not be evaded.

From a global perspective, the major limitation of the Roe "political" thesis is that it works only for the United States. If it was more efficient for large financial institutions to monitor and control industrial corporations (as they did in Germany and Japan), why did not the U.K. evolve in this direction? None of the populist resentment of financial concentration stressed by Roe applied to the U.K., which had a very different political history than the United States. Yet, as will be seen, by the last quarter of the 20th Century, after following a quite different trajectory, the U.K.'s corporate ownership structure looked very much like that of the United States.

To explain the persistence of dispersed and concentrated ownership in different countries, Roe later moved to a more general political theory: because left-leaning countries favor employees over shareholders, he argued, concentrated ownership persists primarily in such social democratic countries as a means of enabling controlling shareholders to maintain close supervision over their managers.[40] If dispersed ownership

---

[39] Id. at 304 (discussing major banks, including the Chase Bank, that used securities affiliates to conduct a national securities distribution business in the 1920s).
[40] See Mark J. Roe, POLITICAL PRECONDITIONS OF CORPORATE GOVERNANCE (2003); Mark J. Roe, Political Preconditions to Separating Ownership from Corporate Control, 53 Stan. L. Rev. 552-560, 577-78 (2000).

were instead to develop, managers would use their greater discretion under such an ownership system to favor the interests of employees over shareholders. Put differently, the inevitable conflicts between managers and shareholders (plus governmental pressure) would lead managers to subordinate shareholder interests to employee interests in these countries. But controlling shareholders could intervene to stop such behavior.

Plausible as this more generalized political theory may be, it seems counterfactual as applied to the U.K. As Brian Cheffins has convincingly shown, dispersed ownership developed in the U.K. during the extended reign of Labour Governments after World War II.[41] Under Roe's theory, the leftward drift of the U.K. during this period should have made controlling shareholders struggle mightily to preserve concentrated ownership. But they did not. Instead, it was precisely at this time that concentrated ownership in the U.K. exited – with a whimper, not a bang. Indeed, Cheffins concludes that "left-wing politics" may have accelerated the divorce of ownership and control in the U.K. because the threat of nationalization caused controlling shareholders to liquidate their blocks.[42]

In any event, Britain at no point restricted commercial banks with a Glass-Steagall Act; nor did it chill institutional investors in their ability to communicate with regard to proxy solicitations or takeovers (as the U.S. once did aggressively and still does to a degree). Yet, even absent these restrictions, British financial institutions did not develop into German or Japanese universal banks; nor did they behave as activist monitors. At most, their level of activism was only marginally higher than that of U.S.

[41] See Cheffins, supra note 27, at 47-51. As he notes, "Britain had a left-wing government all but three years between 1945 and the election of Margaret Thatcher's Conservatives in 1979." Id. at 49.
[42] Id. at 51.

institutions.[43] The conclusion seems inescapable that law has been less of a restraining force than Roe has hypothesized.

The point here is not to claim that Roe's political theory is invalid or that LLS&V were misguided in searching for the variables that distinguished countries with strong securities markets from those with weak ones. But broad brush strokes do not explain the evolution of dispersed ownership, and the convergence of the U.S. and the U.K. in share ownership requires a fuller understanding of both the business models of the principal intermediaries who guided this process and the special environments in which self-regulation, not mandatory law, played a major role.

II. The Spread of Dispersed Ownership in the United States

Dispersed ownership arrived in the United States during the first quarter of the 20th Century, but the developments that paved its way began in the last quarter of the 19th Century. By that point, large industrial empires had formed in the United States in a variety of capital intensive industries: chiefly railroads, steel, mining industries, chemicals and oil. Founder/entrepreneurs – men such as Carnegie, Vanderbilt, Rockefeller, and the DuPonts – controlled these empires, and in the normal course of events, succession problems would inevitably have arisen on the deaths of these founders. In Europe, control would typically stay within the family, or in few cases control would be sold at a premium to an incoming controlling shareholder. But control was seldom sold to the public. One can attempt to explain this difference by saying that Europe lacked an "equity culture" in which investors were ready to invest in shares, but that

[43] For a detailed examination as of the mid-1990s, see Bernard Black and John C. Coffee, Jr., Hail Brittania?: Institutional Investor Behavior Under Limited Regulation, 92 Mich. L. Rev. 1997 (1994) (contrasting behavior of institutional investors in corporate governance and finding real, but marginal, differences).

response only begs the deeper question: why did such a culture not develop? The greater obstacle, as earlier noted, was that control could not be successfully held by the public – at least with sufficient confidence to justify the payment of a substantial premium. Sooner or later, a new control seeker would surreptitiously assemble a control block and either squeeze out the public shareholders at a low price or leave them holding an illiquid security, while the new controlling shareholder extracted high private benefits of control. But events did not work out this way in the United States, and the reasons for its different evolution fall under essentially three headings:

A. The Role of Investment Bankers As Guardians

In 1877, Commodore Cornelius Vanderbilt, then the richest man in America and the founder of the New York Central Railroad, died. The Commodore left a clearly unsuitable heir, William Henry Vanderbilt, who the Commodore had considered a "dunce" and exiled to farm on Staten Island, never training him in the business.[44] William Henry Vanderbilt, who received 87% of the stock in the New York Central under the Commodore's will, was not only untrained, but he quickly exacerbated a pre-existing political controversy between the railroad and the New York State legislature. In 1879, the New York State Assembly held hearings to investigate preferential rates that the New York Central was giving to some oil refiners. Public hostility towards the Vanderbilts was already growing, but it intensified exponentially in the wake of William Henry Vanderbilt's clumsy testimony at these hearings and his infamous remark at this time

[44] For a fuller description of the two Vanderbilts, see Chernow, supra note 38, at 42-43.

that: "The public be damned."[45] New York State appeared to be on the brink of imposing punitive taxes on the New York Central, in large part because of public animosity toward the Vanderbilts and their unrivalled wealth.

Strategists for the Vanderbilts and the New York Central decided that the best way to protect their firm was to have William Henry Vanderbilt sell a large block of his holdings (some 250,000 shares) so that he would become only a minority shareholder and thus reduce the Vanderbilt association with the railroad. But such a sale was no small order and was in fact unprecedented. The problem was not only that public investors might be reluctant to buy, but that knowledge of this impending sale and thus of the overhanging excess supply of New York Central stock might cause its stock price to nosedive.

The sensitive assignment of conducting the sale of the Vanderbilt control block in the New York Central was given to J.P. Morgan & Company, largely because of its Anglo-American structure. Junius Morgan – the father of J. Pierpont Morgan and founder of the firm – had made the family's fortune selling railroad bonds to British investors, and he still ran the London office. Not only did he have the trust of his British clients, but he could quietly sell New York Central stock to those clients without the scale of the massive distribution becoming apparent in the railroad's home market in New York, where full disclosure would have caused its stock price to plummet.

But even sales to Morgan's long-standing loyal British customers were not enough. To pull off this syndication, Morgan had to strike a truce with some of

[45] Id. at 42-43. The full quotation (often wrongly ascribed to the Commodore) was: "The public be damned. I am working for my stockholders." Although this claim of loyalty to shareholders may be a more defensible position, it was a public relations nightmare that immediately elicited a hostile press reaction.

Vanderbilt's foes, including his arch-enemy, Jay Gould, who bought a large 20,000 share block in the offering.[46] Gould and Vanderbilt had long operated competing lines and had bitterly battled for control of the Erie Railroad, sometimes engaging in intense price wars. But could these bitter rivals co-exist in peace? Or would Gould use his initial stake to mount a control fight, now that the ineffectual William Henry Vanderbilt held only a minority stake?

Although such an eventual control fight was a plausible scenario, it never materialized. Rather, it was precluded when J. Pierpont Morgan asserted himself. Demanding a board seat to represent "the London interest,"[47] he skillfully used that seat and proxies from his British bondholder clients to take de facto control of the New York Central board. In so doing, he realized multiple objectives: (1) he held off opportunistic control seekers (such as Gould and other Robber Barons of the era) who could not assemble a control position in the face of his opposition; (2) he served as an effective fiduciary and guardian for his distant British clients, thereby maintaining their loyalty and future business; (3) he was able to negotiate and maintain a truce between adversaries in an industry regularly characterized by ruinous competition (of the kind that economists applaud but shareholders dread); and (4) he used his pivotal position to earn fees for serving the New York Central as its principal underwriter and adviser, performing whatever services might be needed.[48]

[46] Id. at 43. Several other Robber Barons of this era also bought major blocks, including Russell Sage and _.

[47] Id. at 44.

[48] J.P. Morgan & Co. earned an unprecedented $3 million commission for handling this underwriting. Id. at 44. In addition, the New York Central appointed it its fiscal agent to disburse its dividends to its British shareholders. Id. Lucrative fees then were available at a variety of junctures, if one controlled the swing votes.

The episode assured J. Pierpont Morgan's reputation for industrial statesmanship. Not only did he protect his overseas clients, but once on the board, he could guide an industry and steer it clear of "ruinous" price competition – thereby benefitting all shareholders in the industry (at the expense, of course, of consumers). His success was emulated, as the industry learned that investment banker control could be good for everyone (except consumers). Over time, the use of investment bankers as directors to share sensitive information among competitors and mitigate unnecessary competition became increasingly common, until Congress in the Progressive Era sought to end this practice in the Clayton Act, which barred interlocking directors – a move that was largely aimed at the perceived role of investment bankers as the engineers of pricing collusion.

Unique only in scale, the New York Central episode was far from an isolated incident. Earlier, J. Pierpont Morgan had gone on the board in other railroad battles to protect his British client/shareholders,[49] and his father, Junius, had organized a "defense committee" to protect the firm's British clients from the trepidations of Jay Gould in one of the many battles over the Erie Railroad.[50] Rival investment banking firms appear to have also organized small shareholders to resist raids by Robber Barons intent on seizing control.[51] Although J.P. Morgan & Co. had an unrivaled relationship with British investors, other prominent investment bankers had corresponding relationships with other

[49] In 1869, in a smaller but more violent confrontation, J. Pierpont Morgan hired a small army to confront Jay Gould and Jim Fisk (and the latter's army of Bowery thugs) in a shareholder battle for control of the Albany and Susquehanna Railroad, which climaxed in a pitched battle at the annual shareholders' meeting in Upstate New York. Morgan's side won both the physical and legal battle, and he went on the board to protect his British clients. Id. at 30-32.
[50] Id. at 44; see also Gordon, supra note 13.
[51] For example, in the late 1880s, Kidder Peabody and Barings took control of the nearly insolvent Santa Fe Railroad, placing three Kidder Peabody partners on its board and implementing a complex voting trust in order to thwart a takeover attempt by Jay Gould. See Vincent P. Carosso, INVESTMENT BANKING IN AMERICA (1970) at 36-37.

constituencies of European clients: Auguste Belmont had a longstanding relationship with the House of Rothschild and its largely French investors, while Joseph Seligman & Co. and Kuhn Loeb & Co. each represented groups of German investors.[52]

Historically, American investment banks grew up in the middle of the 19th Century to finance the construction of railroads across the American continent. Both because the United States was then a capital-importing nation and because the amount of capital required to build railroads across a continent was vastly greater than that required to build railroads between British or European cities, these investment banks had succeeded only to the extent they could gain the confidence of European investors. But because the railroad industry was often dominated by Robber Barons and other seeming buccaneers and because railroads often became overleveraged and entered bankruptcy, the maintenance of these relationships with distant European clients required American investment bankers also to serve these clients as guardians during the bankruptcy and re-organization process. Although not unprofitable, this role prepared these bankers to similarly serve their clientele when the focus shifted from selling bonds to selling stock. Once again, their natural mission was to protect their European clients from well-known financial predators (of whom, the names Jay Gould, Jim Fisk, Russell Sage and Daniel Drew stood out). Moreover, because their predominant business continued to be the marketing of railroad bonds to European investors, the investment banks had strong incentives in their role as corporate directors to forego any opportunistic or self-seeking

[52] With respect to the Belmont/Rothschild connection, see Chernow, supra note 33, at 40; with respect to Joseph Seligman's relationship to German investors, see id. at 30; with respect to Kuhn Loeb's relationship to investors in France and Germany, see id. at 90.

conduct that might tarnish their reputations. J. Pierpont Morgan appears to have been particularly meticulous in this regard.

This pattern of directors serving on boards to protect dispersed shareholders quickly generalized, and by the turn of the 20th Century investment bankers, often several from the same firm, were on the boards of most major corporations, particularly banks, to protect both dispersed shareholders and management from perceived threats to control.[53] But the investment banks held small, if any, stakes in the corporations they so served.

Here, a central difference emerges between the American and European contexts: American investment banks remained agents and did not seek to take over industrial empires as the founders of those empires died off. Why not? Conceivably, they might have bought control of these firms with financing from their European clients. But such a strategy faced a variety of obstacles. First, it might have placed them in conflict with their European clients. Those clients wanted a safe stream of dividends and a liquid stock. Had J.P. Morgan & Co. sought, for example, to take the New York Central "private" (although that term was not yet known), the buyout group would probably have had to accept additional risk by increasing the firm's leverage and surrendering the liquidity that the New York Central enjoyed as a New York Stock Exchange-listed security. This additional risk might have been unattractive to a clientele looking more for a safe dividend return. Equally important, a large scale buyout transaction was probably then

---

[53] For example, J.P. Morgan & Co. at one point shortly after the turn of the 20th Century held twenty-three directorships in just thirteen banks, and First National City, which worked closely with J.P. Morgan & Co., held fourteen directorships in other banks and a total of thirty-two directorships at financial institutions. See Carlos 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, 665 (1995). By the time of the Pecora hearings in the wake of the 1929 Stock Market Crash, Pecora was able to present charts at these hearings showing J.P. Morgan directors holding 126 directorships at 89 companies. See Chernow, supra note 38, at 366.

beyond the capacity of most American investment banks. In 1879, the Vanderbilt stake in the New York Central was estimated to be worth roughly $100 million.[54] Yet, according to his biographer, J. Pierpont Morgan's annual salary in the early 1870s was only $75,000 per year – princely on a relative scale, but hardly suggesting that his firm could then consummate a major acquisition.[55] In short, American investment banks were not then capitalized on the scale of the House of Rothschild or a major European universal bank.

Taking a firm "private" might also mean the end of a variety of lucrative fees that the investment bank received from a public corporation. J.P. Morgan & Co. typically served its public corporate clients in a variety of roles: underwriter, disbursing agent, and merger adviser. Put simply, serving dispersed shareholders paid well.

Finally, well understood as the idea of "going private" is today, it would have been far harder to conceive at that time because of the organizational challenges involved. J. Pierpont Morgan and his contemporaries were bond salesmen who knew little about running a railroad. In contrast, Vanderbilt was seen as a master of efficiency who had broad vision, understood the business cut costs and maintained a constant stream of dividends to his stockholders.[56] Today, private equity firms know that they can buy the managerial talent to run an acquired business, but that insight was probably beyond the capacity of men experienced only at selling bonds to investors.

---

[54] Id. at 42.

[55] Id. at 32. When, a few years before the Vanderbilt offering, the Morgans formed a partnership with the then larger Drexel firm, J.P. Morgan's capital in the firm was listed at only $350,000. Id. at 34. Even if this did not represent all his capital, it does suggest that his firm was not capable of financing a major takeover on its own at that time.

[56] See Charles Francis Adams, Jr., "A Chapter of Erie," (1871), reprinted in Alfred D. Chandler, Jr., (ed.), THE RAILROADS: The Nation's First Big Business (1965) at 74-79.

For all these reasons, American investment banks performed as agents, rather than as principals, loyally representing both their domestic and European investors. On behalf of these shareholders (and managements), they sought to negotiate industrial peace and restrain competition by assisting industries to maintain collusive pricing. Later, during the Progressive Era, reformers became convinced that the primary function of investment bankers serving as directors was to police cartels.[57] Certainly, investment bankers were well positioned to know the plans and strategies of rival firms and wished to curry favor with all sides. In fairness, it must also be remembered that price-fixing was not clearly illegal before 1890 (with the passage in that year of the Sherman Anti-Trust Act). In any event, the investment banker's fiduciary loyalty ran to its investors, not to the public. For the investment banker, the rise of dispersed ownership meant increased fees from equity underwritings, increasing trading opportunities, and a variety of advisory roles.

That investment bankers as directors added value – both by protecting public shareholders and possibly by restraining competition within industries – is not simply a logical inference. Strong empirical evidence supports this claim. J. Bradford DeLong has found that, in 1911-1912, the presence of a partner at J.P. Morgan and Co. on a corporation's board of directors added approximately 30 percent to that firm's common stock equity value and about 15 percent to the total market value of the firm.[58] Exactly why the presence of a Morgan partner resulted in such a significant market premium has

[57] This was a recurrent theme also in the Pecora hearings in 1934, and it led to legislative restrictions on mutual funds, which are barred from making certain concentrated investments in controlled firms "engaging in the same or similar trades or businesses. . ." See Roe, supra note 17, at 115 (explaining that, as late as 1942, Congress feared that mutual funds would appoint directors to police cartels across an entire industry).

[58] See J. Bradford DeLong, "Did J.P. Morgan's Men Add Value?: An Economist's Perspective on Financial Capitalism" in Peter Temin (ed.), INSIDE THE BUSINESS ENTERPRISE: Historical Perspectives on the Use of Information (1991).

been debated. DeLong theorized that firms with a Morgan partner on its board could better replace inferior managers; other financial economists have argued that it gave such a firm better access to external finance.[59] Both these hypotheses could be valid, but an alternative and simpler hypothesis may also be true: the 30% premium may reflect in part the reduced agency costs that a public corporation with a J.P. Morgan partner faced because it was less exposed to a coercive raid by a Gould or a similar predatory control seeker. In short, the Morgan partners of 1910-1911 might have been doing precisely what J. Pierpont Morgan did for much of his career: protecting their shareholder clients from predatory control seekers, who might either manipulate the stock price or seek to acquire control without paying a control premium.

Undoubtedly, investment bankers on corporate boards faced conflicts of interest, and often they may have been more loyal to the interests of management than to those of the public shareholders. At times, investment bankers may have aligned with management. At other times, controlling shareholders used them so that they could sell their majority interest, thereby obtaining the benefits of diversification, while still relying on their investment bankers on the corporate board to protect their de facto control.[60] In short, by playing a guardian-like role, investment bankers could accomplish multiple (and occasionally conflicting) objectives, sometimes protecting dispersed shareholders from external attack by the Robber Barons of this era, sometimes serving the interests of founders who wanted to remain influential while disposing of their majority block, and

[59] See Ramirez, supra note 53.

[60] When the Guggenheim family sold their controlling block in American Smelting and Refining Company (ASARCO) in 1908, they did so based on the assurances of their advisers that they could still retain de facto control through their investment bankers on the board. See Marco Brecht and J. Bradford Long, "Why Have There Been So Little Block Holdings in America," in Randall K. Morck, A HISTORY OF CORPORATE GOVERNANCE (2007) at 613, 616-617.

sometimes fostering relationships with the new cadre of professional managers (while also assisting all of the above in policing price fixing and similar agreements that assured peace in the industry). Despite these multiple goals, the precondition to any sale of control to the public at an attractive premium was that the public shareholders believed that they would be able to retain control for the long-run. In this sense, the role of the investment banker was indispensible to the rise of dispersed ownership in the United States.

B. The Great Merger Boom of the 1890s

The United States experienced its first great merger boom between 1890 and 1902. By some accounts, as much as one-half of U.S. manufacturing capacity was involved in mergers during this period.[61] Often, these mergers involved most of the firms in an industry, and not infrequently they united firms that already had been loosely connected through trusts, loose price-fixing agreements, or holding company devices. The 1901 creation of U.S. Steel well illustrates this pattern. Negotiated by J.P. Morgan and Andrew Carnegie, it united a host of firms, accounting for the majority of the steel-making capacity in the United States.[62] Although intended to realize economies of scale, it also appears to have been the product of the growing potential for competition between Carnegie's firm and smaller firms in the steel pipe and tube business that were sponsored by J.P. Morgan & Co.[63] The result was America's first corporation with a capitalization

[61] See George Bittlingmayer, Did Antitrust Policy Cause the Great Merger Wave, 28 J. Law & Econ. 77 (1985).
[62] See Chernow, supra note 38, at 83-84.
[63] Id. Carnegie's firm was beginning to move beyond producing crude steel to making finished steel products (such as pipe). This implied both economies of scale and disruptive competition.

of over $1 billion (at a time when the capitalization of all manufacturing companies in the U.S. just reached $9 billion).[64]

What drove these mergers? A popular, if much debated, view is that this merger wave was a response to the passage of the Sherman Antitrust Act in 1890. That Act outlawed price fixing, but did not prohibit mergers among competitors. Hence, if it was unlawful to fix prices across firms, but lawful to merger competitors into a single firm, the latter route became the preferred technique by which to avoid "ruinous competition" and achieve economic rents after 1890.

Although this theory has its critics,[65] there is little doubt that this merger wave (whatever its cause) played a major role in the rise of dispersed ownership at the close of the 19th Century.[66] Some of the best known mergers during this period – for example, the formation of Standard Oil and U.S. Steel – combined the majority of the firms in the industry into a single entity. Inherently, such industry-wide mergers diluted the controlling shareholders at individual firms and created dispersed ownership. At the same time, because these new combined entities were usually oligopolies, their enhanced market power explains why controlling shareholders would happily sell out in such transactions: they could receive a higher premium in a merger transaction because oligopolies create value for shareholders. Revealingly, Andrew Carnegie sold his company in the U.S. Steel transaction for bonds and took no stock in U.S. Steel.[67]

---

[64] Id. at 82-83.

[65] See Donald J. Smythe, The Supreme Court and the Trusts: Antitrust and the Foundations of Modern American Business Regulation from Knight to Swift, 39 U.C. Davis L. Rev. 85 (2005) (arguing that the trend toward increased concentration preceded the Sherman Act and largely provoked it).

[66] For the fullest statement of this theme, see Brian R. Cheffins, Merger and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century, 51 Am. J. Comp. L. 473 (2003).

[67] See Chernow, supra note 38, at 84.

Clearly, he thought he was selling at the top of the market and at a value beyond that which any incoming controlling shareholder would pay him.

Skeptics doubt that antitrust law played a critical role in causing the merger wave of the 1890s, and they instead attribute that wave to the technological revolution caused by the growth of railroads.[68] Railroads vastly increased the size of the market for manufactured goods and enabled manufacturers to profit from economies of scale. Improved communications – first the telegraph and later the telephone – also opened new and enlarged markets. Still, significant capital investments were necessary to introduce these economies of scale, and competition produced overinvestment and excess capacity. Alfred Chandler has observed that intense pressures developed within American industry to escape from competition, which pressures were "particularly strong in the new capital and energy-intensive industries where several entrepreneurs had simultaneously adopted new technologies of production."[69] In response, business leaders sought ways to reduce uncertainty and ensure high rates of return by reducing competition. Economists of this era even developed theories of "ruinous competition" to justify cartels and similar practices.[70] Although price-fixing agreements were used, cartels prove unstable and tended to break down; in contrast, mergers produced a permanent consolidation that inherently reduced competition and ensured higher returns.

Ultimately, for our purposes, it is not necessary to choose between these overlapping theories of what caused this merger wave. Both explanations stress reasons why entrepreneurs turned to mergers, and investment bankers naturally rushed to

[68] See Smythe, supra note 65, at 144-145.
[69] See Alfred D. Chandler, Jr., THE VISIBLE HAND: The Managerial Revolution in American Business (1977) at 72.
[70] For an overview of these justifications, see Smythe, supra note 65, at 136-137.

facilitate this new trend, thereby generating very high fee income. Historically, merger waves have been accompanied by stock market booms, and the 1895-1904 merger wave was no exception.[71] For example, U.S. Steel's shares soared from $38 when it was floated in 1901 to $55, but then plunged to $9 by 1903.[72] Although it might reasonably be debated whether merger waves create stock market bubbles, or vice versa, the financial community, and the Morgan firm specifically, benefited from the phenomenon and saw mergers as a source of profits. Even if one is not willing to deviate from an assumption of strong market efficiency and doubts this stock bubble explanation, one can still fall back on the explanation that these transactions offered high premiums because they promised oligopolistic market power. Either way, the bottom line is the same: mergers diluted blockholders and facilitated dispersed ownership.

The merger wave of the 1890s had its corollaries in England and Europe, but it was more pronounced in the United States, because in the United States (1) the technological revolution ushered in by transcontinental railroads had generated the greatest potential for improved economies of scale and enlarged markets; (2) the problems of overinvestment and excess capacity had repeatedly frustrated industry leaders in the U.S.; and (3) cartels remained legal in much of Europe, thus reducing the incentive to merge. Also, even if new technologies created potentially enlarged markets in Europe, these new markets intersected with national boundaries, where tariffs and legal issues restricted the full realization of the potential economies of scale. Hence, although mergers and industrial concentration increased throughout the industrialized world during this period, the rate of increased concentration was greatest in the United States. With

[71] Dennis C. Mueller, "Mergers and the Market for Corporate Control" at 19.
[72] Id. at 18.

greater concentration through mergers came greater dispersed ownership. Once again, the historical evidence explains the rise of dispersed ownership without resort to legal rules protecting minority shareholders.

C. Self-Regulation and the Role of the New York Stock Exchange

Stock exchanges are natural allies of dispersed ownership. Because they profit from increased trading, they do better when the structure of share ownership involves many small shareholders who will constantly be making portfolio revision decisions and trading as a result. In contrast, controlling shareholders infrequently trade and inherently deprive the market of liquidity.

Stock exchanges developed in the U.S. and the U.K. well before the Industrial Revolution (principally to trade debt securities), but they grew exponentially in the wake of that revolution. Although stock exchanges existed in Europe, they encountered resistance there from the large banks who regarded them as competitors, and they actually shrank in size as the 20th Century dawned.[73] During the late 19th and early 20th Centuries, the more centralized governance regimes in France and Germany were acutely conscious of the need to develop defense industries and sought to plan their economic development around this goal. They realized that they could better manage and direct economic development through a close partnership between the Ministry of Finance and the largest banks. In contrast, stock exchanges could not be as easily coordinated or controlled and were unpredictable in terms of how they would allocate capital.

Because the political economies of the U.S. and the U.K. were much more decentralized, these same issues of economic planning never arose. Indeed, the U.S. in

[73] See Raghuram C. Rajan and Luigi Zingales, The Great Reversals: The Politics of Financial Development in the Twentieth Century, 69 J. Fin. 5 (2003).

this era did not even have a central bank, and its banking structure was highly fragmented as the result of a Federal system that kept banks confined within a single state. Hence, in the absence of natural rivals or an activist state, stock exchanges grew more rapidly in these countries (particularly in the U.S.) and faced less resistance. But the stock exchanges in these two countries developed in different directions, and this helps explain the later arrival of dispersed ownership in the U.K. than in the U.S.

Unlike the London Stock Exchange ("LSE"), the New York Stock Exchange ("NYSE") faced stiff competition throughout the late 19th Century from other stock exchanges (indeed, more companies were listed on the Boston Stock Exchange as of 1900[74]). In response, the NYSE sought to develop its brand as a high-quality exchange that listed only "safe," low-risk companies.[75] Economic reasons underlay the different behavior of the two exchanges: the NYSE was a closed exchange, which did not admit new members, but instead outgoing members sold their seats to incoming members. In contrast, the LSE was an open exchange, always ready to admit new brokers and list virtually any security that would trade.[76] This difference created a stronger desire on the part of the NYSE to increase the value of its seats by enhancing the NYSE's reputational capital.

Also, the NYSE employed fixed brokerage commissions, which naturally gave it a higher cost structure. Other exchanges could trade securities at lower cost, and this

---

[74] Prior to 1900, the Boston Stock Exchange was the principal market for industrial securities. See Carosso, supra note 51, at 44. It had gained this role by listing New England textile mills, whose shares were largely distributed to investors in its community.

[75] For a fuller discussion of the NYSE's strategy and the organizational differences between the NYSE and the LSE, see John C. Coffee, Jr., supra note 26, at 34-40.

[76] Between 1850 and 1905, the number of brokers admitted to the LSE rose from 864 to 5567, while the seats on the NYSE stayed constant. Id. at 34-35. As of 1900, the LSE listed 3631 different issuers of securities, while the NYSE listed only 1157. Id. at 36. This difference was largely the product of the NYSE's decision to reject most listing applications.

particularly made the NYSE an uneconomic venue on which to trade lower-priced securities. Arguably, the NYSE made a virtue of this necessity by marketing itself as a selective exchange that would not list low-priced "penny" stocks. Clearly, there was a quality differential between the securities listed on the NYSE versus those listed on its rivals. The NYSE's high listing standards also protected it from the danger that the failure of a high-risk company could cause the failure of a broker that dealt heavily in its stock, which latter failure would have broad repercussions because a broker's failure would cause its liabilities to fall on all NYSE members.[77]

Given these differences in organizational structure, it logically followed that the NYSE took a more activist approach to listing standards and issues of corporate governance than the LSE. In frequently rejecting listings and insisting on an adequate earnings track record before listing an issuer, the NYSE was distinguishing itself from its competitors and marketing itself as the guardian of public shareholders. This guardian role manifested itself in two concrete ways: (1) the NYSE, beginning in 1900, insisted that its listed companies publish annual audited financial statements, and (2) it protected shareholder voting rights by resisting attempts by issuers to deviate from the norm of "one share, one vote."[78] These steps were taken by a private body as a matter of self-regulation, not mandatory law, but the result was to attract public shareholders to invest in NYSE stocks as safer and better monitored.

The point here is not that the NYSE was altruistic or public regarding, but that it pioneered dispersed ownership by engendering public confidence (which others later exploited). Although the NYSE was younger and smaller than the LSE, many of the

[77] Id. at 36.
[78] Id. at 37-39.

companies that listed on it became widely held shortly after 1900. As of 1913, the Pennsylvania Railroad had 86,804 shareholders; AT&T had 53,737 shareholders, and U.S. Steel, organized only in 1901, had 44,398 common shareholders and 77,420 persons holding its preferred stock.[79] This degree of shareholder dispersion was measurably ahead of similar companies in the U.K. and few of these three companies had any clear controlling shareholder.

A distinctive feature of the spread of dispersed ownership in the United States was that retail shareholders, not institutional investors, were induced to buy the blocks sold by controlling shareholders. Of course, neither pension funds nor mutual funds existed to any significant degree at this point, and the major investment banks and merchant banks of this era largely avoided investments in speculative securities.[80] Thus, individual shareholders had to be convinced that equity securities were more than speculative gambles. In part, the NYSE prepared the way for this transition by steadily communicating that its listed securities were sound and safe investments.

Well before 1900, the New York Stock Exchange had come to view itself as the guardian of the financial quality of the issuers listed on it. To be sure, its selective listing standards were for self-interested reasons,[81] but they still contrasted sharply with the London Stock Exchange, which was basically prepared to list any company that could be traded. Identifying its interests with those of public shareholders, the NYSE began in

---

[79] See R.C. Michie, THE LONDON AND NEW YORK STOCK EXCHANGES: 1850-1914 (1987) at 222-23.

[80] J.P. Morgan & Co. remained primarily a wholesale bond house and generally (but not always) avoided investments in speculative securities. See Chernow, supra note 38, at 305. J. Pierpont Morgan appears to have abided by his father's iron rule to avoid speculative securities. Id. at 84.

[81] The NYSE also feared that listing risky stocks would produce predictable insolvencies among its members when such a listed company failed. See Coffee, supra note 26, at 36-37. Indeed, the U.S. financial markets had witnessed several such panics in the late 19th Century.

1900 to require newly listing companies to publish audited financial information, and some financial historians date the advent of modern financial reporting from this moment.[82]

D. The Full Flowering of Dispersed Ownership: 1900 to 1930

1900 supplies a useful reference point. Based on data he compiled on share ownership at forty large companies as of 1900, Herman concludes that "the separation of ownership and control was already well advanced by the turn of the century."[83] Specifically, he finds that only five of these forty companies (or 12 ½%) had a majority shareholder;[84] these five were all industrial corporations, as railroads and utilities had already fully achieved dispersed ownership and uniformly lacked majority shareholders.

Thereafter, the pace quickened. Cheffin and Bank use data compiled by the National Civic Federation, which followed 75 large U.S. corporations from 1901 to 1913.[85] This roughly contemporaneous survey found that the aggregate number of shareholders in these 75 firms rose from 141,000 in 1901 to 415,000 in 1913.[86] Similarly, Warshow followed the growth in shareholders in a different sample of 68 firms from 1900 to 1923.[87] Between 1900 and 1913, he found that the number of shareholders had at least doubled in 31 of these firms and that the aggregate number of shareholders in all rose from 342,000 to 769,000.[88]

---

[82] See David F. Hawkins, "The Development of Modern Financial Reporting Practices Among American Manufacturing Companies," in MANAGING BIG BUSINESS (Richard Tedlow & Richard John, Jr. eds 1986) at 166-167.
[83] Edward S. Herman, CORPORATE CONTROL, CORPORATE POWER (1981) at 67.
[84] Id.
[85] See Cheffin and Bank, supra note 2, at 13.
[86] Id.
[87] H.T. Warshow, The Distribution of Corporate Ownership in the United States, 39 Quarterly Journal of Economics 15 (1924).
[88] Id. at 21-25.

During the 1920s, the rate of growth accelerated. One measure of this growth is the number of companies listed on U.S. stock exchanges, which number rose from 682 in 1900 to 970 in 1915 and, finally, to 2,659 in 1930. By one estimate, the number of individuals owning stock in listed companies rose from 500,000 in 1900 to 2 million in 1920 and to 10 million by 1930.[89]

Driving this growth was, of course, a stock market bubble that arose and exploded at the end of the 1920s. Behind that bubble were again investment banks, but this time it was a different type of investment bank. Mass marketing and retail advertising were distinctively American inventions. Not surprisingly, some American underwriters proved to be as adept (or as irresponsible) at marketing equity securities as other American retailers were at selling cars, tobacco, soft drinks, or gasoline to the American public. During the 1920s, National City Bank, under its flamboyant CEO, Charles Mitchell, became the largest U.S. underwriter of securities, surpassing J.P. Morgan & Co. largely by applying mass marketing techniques to the sale of equity securities. Chernow describes Mitchell as bringing "a carnival tone to securities marketing" and turning his brokers into "garrulous hucksters."[90] These retail-oriented banks (which, unlike Morgan, did seek retail deposits and thereby gained greater underwriting and distributional capacity) were clearly in a different business from "wholesale" firms, such as J.P. Morgan & Co. and Kuhn, Loeb, but their style was distinctively American. During the 1920s, several major banks (including Chase) incorporated separate securities affiliates so as to be able to outflank limits on interstate banking, and this enabled them to operate

[89] See Jonathan Barron Baskin & Paul Miranti, Jr., A HISTORY OF CORPORATE FINANCE (1997) at 190. This and other estimates are assessed at greater length in Cheffin and Bank, supra note 2, at 15-16.
[90] See Chernow, supra note 38, at 304.

coast to coast.[91] By the end of the 1920s, the number of securities dealers in the United States had risen from 250 at the beginning of World War I to 6,500 by 1929.[92] By 1929, in a nation of 120 million, some 1.5 to 3 million U.S. citizens regularly played the stock market.[93] These new marketing techniques ultimately resulted in a record bubble and the Stock Market Crash of 1929, but by then dispersed ownership had become an accomplished fact.

III. The Rise of Dispersed Ownership in the United Kingdom

Brian Cheffins has recently marshaled the evidence showing that dispersed ownership came later to the U.K. than to the U.S., probably arriving in fully developed form only after 1970.[94] Some of the reasons for this delay have already been surveyed; the factors that accelerated the appearance of dispersed ownership in the United States were simply not present (at least to the same extent) in the United Kingdom. The 1890s merger boom was only faintly felt in the U.K. (possibly because British antitrust law was also much less developed); as a result, there was less dilution of U.K. controlling shareholders. Because the shareholders of the LSE (who were different from its brokers or seat holders) profited from selling new seats, the LSE had less interest in maximizing instead the value of existing seats. Desiring to trade any security that could be traded, the LSE was less selective about listings, did not impose corporate governance-related listing standards, and did not seek to present itself as a proactive guardian of public shareholders (as the NYSE did). Investment bankers in the U.K. neither needed to raise capital across the Atlantic nor confronted adversaries quite as predatory as the American Robber

[91] Id. at 304.
[92] Id. at 303.
[93] Id.
[94] See Cheffins, supra note 27, at 12-15.

Barons of the late 19th Century; hence, they were also less motivated to undertake a guardian role. Finally, the enormous and growing American middle class was convinced by retail-oriented underwriters to buy equity securities in the 1920s, while nothing similar occurred in the U.K. (possibly because of greater class stratification and wealth inequalities).

That dispersed ownership came to the U.K. does not seem to have been the result of any distinctive legal rules or judicial concern for the rights of minority shareholders. British academics agree that "from a legal perspective, the United Kingdom was not a protective jurisdiction for minority shareholders during the first half of the twentieth century."[95] In particular, the judiciary largely maintained a "hands-off approach," and certain legal remedies, such as the appraisal remedy and the derivative action, were significantly less available than in the United States.[96] Exculpatory provisions in corporate charters were common and enforceable, thereby undercutting the duty of loyalty,[97] and shareholder ratification could waive most alleged breaches of a legal duty.[98] Although U.S. legal remedies may have been marginally stronger in this period, the fairest generalization is that courts in both countries were reluctant to become involved in the internal affairs of a business corporation. Legal protections for minority

[95] See Brian R. Cheffins, Does Law Matter? The Separation of Ownership and Control in the United Kingdom, 30 J. Legal Stud. 459, 469 (2001). Cheffins adds: "[N]either companies legislation nor relevant common law principles afforded much explicit protection to minority shareholders." Id. See also Julian Franks, Colin Mayer, Stefan Rossi, Ownership: Evolution and Regulation, ECGI Finance Working Paper No. 09/2003 (available at http://ssrn.com/abstract=354381 (2008)) at 11-18 (arguing that formal investor protections only emerged in the second half of the 20th Century).

[96] Cheffins observes that "derivative actions were relatively uncommon and undeveloped since the judiciary was reluctant to give minority shareholders standing to sue on a company's behalf." Id. at 470. Under Foss v. Harbottle, 2 Hare 461 (1843), at least as that decision came to be interpreted by later cases, a derivative action could not be brought in the U.K. so long as the alleged misconduct was capable of ratification by an independent majority of the shareholders. This is a more restrictive position than U.S. law took.

[97] Id. at 470; see also Franks, Mayer, and Rossi, supra note 95, at 14 (discussing leading cases).

[98] Id.

shareholders and the quality of disclosure improved in both countries after World War II, but this development followed, and did not precede, the separation of ownership and control.

From this perspective, the United Kingdom's experience seems inconsistent with the hypotheses of both LLS&V and Mark Roe. Most obviously, the U.K. did not provide the legal protections for minority shareholders that LLS&V view as the precondition to dispersed ownership. Nor was the U.K. characterized by a populist distrust of concentrated financial power or by a federal system that fragmented financial institutions. Hence, under Roe's reasoning, large financial institutions should have controlled most British corporations – but clearly such concentrated financial power did not arise until well after World War II.

Although not all commentators agree,[99] dispersed ownership appears to have developed at a slower pace in the U.K. Initially, it spread within local communities (as in the United States), as companies sold shares to investors in the vicinity of their headquarters. Studying the shareholder records of 26 companies incorporated around 1900, Julian Franks, Colin Mayer and Stefano Rossi found that, as of 1910, 56% of the

[99] Leslie Hannah has strongly dissented from the conventional view and challenged what he terms "the erroneous belief that America led in divorcing ownership from control." See Leslie Hannah, The Divorce of Ownership from Control from 1900: Recalibrating Imagined Global Historical Trends, 49 Business History 404, 423 (2007). His principal focus is on the ownership of railroads, utilities and industrial companies in the U.S., Britain, France and Germany at the turn of the 20th Century. He concludes that, as of 1900, the United States lagged behind these other countries, largely because it had fewer companies with listed equity securities. Although Hannah has shown that U.K. banks and railroads did have dispersed ownership as of 1900, his claim that U.K. share ownership was more dispersed than that in the U.S. seems dubious. His critics have responded that he undercounted U.S. equities by counting only NYSE listed firms. See Cheffins and Bank, supra note 2, at 6-8. As earlier noted, the NYSE was extremely selective in accepting listings and many public companies traded on other exchanges or on an over-the-counter basis. In any event, the studies by Herman and Warshow show broadly dispersed ownership in the numerous U.S. companies by 1913. See supra notes 83-88.

common shareholders lived within six miles of the corporation's headquarters.[100] The New England textile mills had a similar experience, and both examples suggest that entrepreneurs can market their shares locally to investors who know them. To this extent, as Franks, Mayer, and Rossi argue, trust is probably more important than legal protections in encouraging investment,[101] and trust was founded on personal relationships, which kept ownership local. Still, even if shares were being sold to local investors, control remained with the founders and their families; little, if any, evidence suggests that powerful financial institutions assembled significant stakes in these companies.

Moving forward to 1920, Franks, Mayer and Rossi used a random cross-section of 53 companies quoted on the LSE and found that the largest shareholder held 20.8% of the shares; further, in only 43% of these companies did the largest shareholder own less than 10%.[102] Such evidence shows the glass to be half full: non-controlling public shareholders owned the majority of the stock, but control was likely still in the hands of a small insider group. This pattern continued between the two World Wars. In a well-known study, P. Sargant Florence compiled a data set, as of 1936, of 82 manufacturing and commercial companies and found that 59% of these companies had a "dominant ownership interest," 32% were "marginal," and only 9% had no dominant shareholder or

---

[100] See Franks, Mayer and Rossi, supra note 95, at 33-34. They further report that the median distance between shareholders' addresses and the corporate headquarters was 15.4 miles. Id. at 33.
[101] Id. at 31-32.
[102] Id. at 19-20; see also Cheffins, supra note 27, at 12-14. In addition, Cheffins notes that the ten largest shareholders in this sample appear to have owned collectively on average some 43% of the stock. Id. at 297. This suggests that a fairly compact and cohesive insider group held control.

shareholder group.[103] In short, although these companies generally had a substantial number of shareholders, there was still no separation of ownership and control.

Three studies have focused on ownership concentration as of approximately 1950. One surveyed the one hundred largest U.K. manufacturers (as of 1970) and found that (as of 1950), a thin majority (50 out of 92) were still under family control.[104] Franks, Mayer and Rossi, examined fifty-five listed companies, and found that 49% of these firms could be considered to be "widely held," based on the criterion that no single shareholder held 10% of the stock.[105] This was marginally up from 43% in their survey for companies as of 1920, but the largest shareholder in 1950 held only 15% (down from their 20.8% figure for the largest shareholder in their 1920 survey).[106] Finally, a follow-up study by Florence examined 98 "very large" manufacturing and commercial companies as of 1951 and found 41% of them had a dominant shareholder, 42% were marginal, and 17% had no dominant shareholder.[107] Thus, based on Florence's data, between 1936 and 1951, the percentage of U.K. firms in which control and ownership had indisputably separated had nearly doubled – from 9% to 17%. This was change, but the Berle/Means model was still very far from well established.

Commentators have generally opined that "family capitalism" in the U.K. declined during the 1950s and 1960s.[108] Channon finds that, of the 100 largest British

---

[103] P. Sargant Florence, The Logic of British and American Industry: A Realistic Analysis of Economic Structure and Government (1953), 187-90, 194.
[104] Derek F. Channon, THE STRATEGY AND STRUCTURE OF BUSINESS ENTERPRISE (1973).
[105] Franks, Mayer and Rossi, supra note 95, at 20; see also Cheffins, supra note 27, at 13.
[106] Id.
[107] P. Sargant Florence, Ownership, Control and Success of Large Companies: An Analysis of English Industrial Structure and Policy 1936-1951 (1961).
[108] See Cheffins, supra note 27, at 14 (citing sources); see also John F. Wilson, BRITISH BUSINESS HISTORY, 1720-1944 (1995) at 190-191.

manufacturing companies, only 30% still had "family control" as of 1970.[109] Still, large ownership blocks remained common. Leech and Leahy, using data from the 1983-1985 period, surveyed 470 UK-listed companies and found 34% had a shareholder owning at least 20% and 61% had a shareholder owning 10% or more.[110] Only with the 1990s does a study by LaPorta, Lopez-de-Silanes, and Shleifer find that large ownership blocks had largely disappeared, at least among the largest U.K. companies. Surveying the 20 largest UK publicly quoted companies, they find that none had a 20% blockholder and only two had a 10% blockholder.[111] Other, more recent studies, employing much larger samples, have replicated this result, finding in common that the vast majority of U.K.-listed companies lacked a shareholder owing a 25% block.[112] In the absence of such a large shareholder, ownership does appear to have at last become separated from control.

This does not mean, however, that evolution of dispersed ownership in the U.K. followed the American pattern. One difference stands out: in the U.S., the appearance of broadly dispersed ownership preceded the rise of the institutional investor, but in the U.K., it clearly followed their rise and was dependent on it. That is, U.S. public corporations had become widely held during the first quarter of the 20th Century – well

[109] See Channon, supra note 104, at 75.

[110] Dennis Leech and John Leahy, "Ownership Structure, Control Type and Classifications and the Performance of Large British Companies," 101 Economic Journal 1418, 1421-23, 1435 (1991).

[111] Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, supra note 7, at 474, 492-93.

[112] Goergen and Rennebog found that 85% of the companies in their random sample of 250 listed companies lacked a 25% blockholder. See Marc Goergen and Luc Renneboog, Strong Managers and Passive Institutional Investment in the U.K., in Fabrizio Barca, Marco Brecht, (eds) THE CONTROL OF CORPORATE EUROPE (2001) at 259, 264. They found that on average the largest block was 15%. Mata Faccio and Larry Lang examined 1,953 publicly traded U.K. companies and found that in 63% no shareholder controlled a 20% block. See Mata Faccio and Larry H.P. Lang, The Ultimate Ownership of Western European Corporations, 65 J. Fin. Econ. 365, 379 (2002). Christopher van der Elst found that 68% of the companies in his sample of 1,333 publicly traded U.K. companies lacked a 25% blockholder. See Christopher van der Elst," The Equity Markets, Ownership Structures and Control: Towards an International Harmonization" in Klaus J. Hopt and Eddy Wymeersch (eds), CAPITAL MARKETS AND COMPANY LAW (2005) at 3, 41-42.

before the rise of institutional investors, which came largely after World War II in both countries (with the U.K. again lagging marginally behind the United States). Thus, in the United States, the transition went through three stages: from family control to broadly dispersed retail ownership to its current form of dispersed institutional ownership. In the U.K., that middle step appears to have been largely omitted, with the transition instead being directly from family control to institutional ownership. This is an important simplification because it clarifies who were the sellers and who were the buyers, enabling us to focus on what caused them to transact.

In overview, three different forces converged to produce a delayed separation of ownership and control in the U.K.: (1) the rise of institutional investors; (2) an active merger market, which included the liberal use of hostile takeovers; and (3) tax laws that pressured controlling shareholders to sell control and that invited institutional investors to buy it.

A. The Growth of Institutional Ownership

As of the early 1930s, individual investors held over 80% of the securities traded on the LSE, and even as of 1957, individuals still held 66% of the shares of public companies in the U.K.[113] But within a dozen more years, this percentage fell to less than a majority.[114] By 1991, pension funds and insurance companies together held 51% of the shares of U.K. public companies, up sharply from 9% in 1957 and 33% in 1975.[115] Unit trusts and investment trusts – collective investment vehicles resembling the American

[113] See Cheffins, supra note 27, at 344.
[114] Id.
[115] Id. at 345. The holdings of pension funds peaked at just over 30% around 1993 and then declined. Insurance rose more gradually from around 10% in 1957 to over 20% by the end of the 1990s and then also declined. Id. at 88 (Figure I).

mutual fund – held a much smaller percentage of shares, probably never exceeding 8% prior to 2000.[116] In the early 1980s, the lines crossed for individuals and pension funds, with individual ownership falling from 66% in 1957 to around 20% in the early 1990s, while pension funds rose from under 5% in 1957 to a peak of over 30% around 1993.[117] The mathematically inescapable fact about the structure of share ownership in the U.K. is that institutions were persistent buyers and individuals persistent sellers from at least 1957 to at least the early 1990s.[118]

What explains this pattern? No comprehensive description will be attempted of why one group was consistently optimistic and the other consistently pessimistic over so long a period. The answer probably lies more in the fact that institutional investors (most notably insurance companies and pension funds) had limited alternatives to equity securities to fund their own future obligations. That individual investors sought exit over this long a period can be explained by multiple factors: (1) a general stagnation in the British economic outlook from 1957 through the early 1990s; (2) an increasingly regulatory stance taken by U.K. corporate law (which may have reduced the private benefits of control for controlling shareholders and so encouraged them to sell[119]); (3) a merger boom which did offer attractive premia, and, most of all (4) changing tax considerations that forced controlling shareholders to liquidate their blocks. This desire

---

[116] Id. at 89 (Figure V).
[117] Id. at 88 (Figure I).
[118] This is clearly shown by Cheffin's Figure I. Id. at 88. Institutional investors did not simply buy in the secondary market; they also subscribed heavily in primary offerings, but this distinction changes nothing and had only a reinforcing impact.
[119] Cheffins argues that post World War II changes in British corporate law and stock exchange regulations may have encouraged controlling shareholders to sell and institutional investors to buy. See Cheffins, supra note 27, at 356 to 360. The major amendments to the British Companies Act were in 1948, 1967 and 1981. However, Cheffins finds that the 1948 Act did not fundamentally change "the legal position of corporate insiders and minority shareholders." Id. at 328. The LSE's listing rules were also extensively revised in 1986. Id. at 357-58.

for exit was accommodated by the rise of institutional investors in the U.K. But the appearance and growth of U.K. pension funds seems an exogenous fact, attributable to the Labor Government's egalitarian agenda and not explainable in terms of any desire to influence corporate governance.

B. The British Merger Movement

Franks, Mayer and Rossi measured changes in ownership structure on a decade-by-decade basis for a sample of 60 companies throughout the 20th Century (40 of which companies were incorporated around 1900 and the other 20 around 1960).[120] They conclude that the "overwhelming use to which equity issuances were put," both in the first and second half of the 20th Century in the U.K., was to fund mergers and acquisitions.[121] To the extent that incumbent blockholders were diluted, mergers then were the primary cause. Similarly, Florence followed some 30 "very large" firms that he classified as "owner controlled" as of 1951 and finds that 25 of these 30 companies experienced major changes in ownership structure between 1951 and 1980, generally as the result of merger activity.[122] During this brief period, each of these 25 companies eliminated two tier capitalization voting structures that gave founder/insiders greater voting rights.

Although, prior to the middle of the 20th Century, mergers had been relatively uncommon events in the case of firms listed on the LSE, some 43% of publicly listed commercial and industrial companies in the U.K. were taken over between 1957 and

---

[120] See Franks, Mayer and Rossi, supra note 95, at 24-29.
[121] Id. at 26. Brian Cheffins is, however, skeptical of this conclusion, given the small sample size and extreme longevity of this sample. See Cheffins, supra note 27, at 17.
[122] Florence, supra note 107, Appendix A; for an analysis of this data, see Cheffins, supra note 27, at 307-310.

1969.[123] In substance, the U.K. experienced a merger wave in this era that was functionally equivalent to the U.S. merger wave of the 1890s. The leading difference was that many of these acquisitions were made by conglomerates and do not appear to have been attempts to organize oligopolies or increase market share. Sometimes, the acquirer would already have dispersed ownership, and sometimes it would have a controlling shareholder group. Either way, repetitive mergers produced an acquisition-driven dilution of ownership. In addition, as the Florence data discussed above indicates, an acquirer that wished to make acquisitions using its stock as currency needed to eliminate those features (such as unequal voting rights or non-voting classes) that made its stock an unattractive currency. Hence, control blocks weakened in a variety of ways.

C. The Role of Tax Law

Brian Cheffins' careful analysis of the rise of dispersed ownership in the U.K. places tax incentives at center stage. Tax considerations both (1) induced blockholders to liquidate their blocks, and (2) encouraged institutional investors, who enjoyed relative tax immunity, to buy.

On the sell side, high corporate tax rates, and particularly an excess corporate profit tax imposed on the eve of World War II, eclipsed corporate profits.[124] An especially punitive feature of the post World War II tax system was a provision that denied "director controlled" companies the ability to deduct remuneration paid to employee directors.[125] Individual income tax rates also soared up to a maximum taxable

[123] See Douglas Kuehn, TAKEOVERS AND THE THEORY OF THE FIRM (1975), 9, 153. For related studies of the impact of mergers on the structure of share ownership, see Cheffins, supra note 27, at 309-310.
[124] Cheffins, supra note 27, at 321-328.
[125] Id. at 322-23.

rate of 95% for taxable income over 20,000 pounds.[126] The combination of high tax rates and the denial of a deduction for remuneration paid to insiders serving on the board essentially eliminated managerial employment as an attractive private benefit of corporate control.[127] British tax law was also dividend unfriendly, as such investment income was subjected to a special surcharge.[128]

Estate taxation probably provided the principal motive for blockholders to exit. Following World War II, the Labour Government raised death duties across the board, with the 50% rate beginning at estates exceeding 100,000 pounds and with the maximum rate being 80%.[129] To avoid such confiscatory taxation, tax planners urged controlling shareholders to sell their control blocks prior to death and make inter vivos transfers. In this process, family businesses usually sold their control blocks and then placed the cash proceeds of these sales into long-term trusts.[130]

On the buy side, pensions and insurance received relatively favorable tax treatment, thus creating a stronger market for these products.[131] Probably as a result, the total financial assets of pension funds grew 32 times between 1952 and 1979, and by the 1970s, pension funds accounted for approximately one-third of all personal savings in the U.K.[132] As money flooded into pension funds, there was little practical alternative for money managers but to invest in equity shares. Insurance companies also increased their allocation of assets to equities from 10% in 1946 to 16% by 1956 and to 21% by the early

[126] Id. at 823.
[127] Id. at 324.
[128] Id. at 325.
[129] Id. at 326-327.
[130] Id. at 327-328.
[131] Id. at 346-347.
[132] Id. at 348.

1960s.[133] Exchange controls, initially introduced in 1947, greatly limited the ability of U.K. institutional investors to invest in foreign equities.[134] As a result, U.K. capital was "trapped" in domestic equities (which did at least outperform fixed income securities during this period). These exchange controls were largely abolished in 1979, but by then dispersed ownership had largely arrived.

IV. A Comparison of the U.S. and the U.K. Experiences

The first conclusion is the simplest: Exogenous factors largely explain the rise of dispersed ownership in both the U.S. and the U.K. In the U.S., the merger wave of the 1890s provides the factor that best explains the timing of this transition. In the U.K., tax considerations similarly supply the primary explanation for the break-up of family ownership. High income and estate taxes, partly necessitated by World War II and partly the product of a Labor Government intent on achieving a more egalitarian distribution of wealth, forced blockholders to exit, and the tax-induced flood of money into pension funds and insurance products created a new class of buyers. Corporate and securities law played little role in inducing this transition. Arguably, but for the U.S. merger wave and the changes in the U.K.'s tax laws, dispersed ownership might have remained only a minority pattern and not the principal form of ownership in both countries.

More, however, must be said. In explaining the appearance of the Berle/Means corporation in the U.K., Cheffins disagrees with Franks, Meyer and Rossi.[135] Cheffins places the British tax laws at stage center in his account, while Franks, Meyer and Rossi give greater emphasis to the creation of trust and the impact of mergers. Who is right? At

---

[133] Id. at 350.
[134] Id. at 352-353.
[135] In particular, Cheffins discounts Franks, Meyer and Rossi's arguments about the need for trust and deems the concept of trust "ultimately unhelpful." See Cheffins, supra note 27, at 41.

least in part, their disagreement may stem from their focus on different developments. In overview, the separation of ownership and control needs to be broken into two stages: (1) the appearance of substantial dispersed ownership among minority shareholders; and (2) the eventual break-up of the control blocks that still dominated these firms as of the foregoing stage. In the U.K., the appearance of firms with large and numerous minority owners came well before the dilution of controlling blockholders, while in the U.S. much less of a time lag separated the two stages. Although the U.K.'s tax laws may explain the dilution of controlling blockholders, they cannot explain earlier broad dissemination of stock into public hands. Retail investors did not buy stock because controlling shareholders faced tax problems. Here, Franks, Meyer, and Rossi properly emphasize the role of mergers and the creation of trust.[136] Trust is an ineffable quality and is usually based on personal knowledge. As a result, few entrepreneurs could hope to establish sufficient personal contacts to generate trust on the part of a broad class of minority shareholders, and ownership was therefore likely to stay local (as Franks, Meyer and Rossi find that it did in the U.K. until well into the 20th Century).

This finding should not surprise. A strong bias in favor of domestic securities on part of international money managers has been well established in the economic literature, and even domestic money managers exhibit a strong preference for firms locally headquartered near their offices.[137] Whether one explains this investor preference in terms of trust or asymmetric information, the fact remains that investors tend to prefer geographically proximate investments. As a result, for ownership to disperse beyond a

---

[136] See Franks, Meyer, and Rossi, supra note 95, at 31-34.
[137] See Joshua D. Coval and Tobias J. Moskowitz, Home Bias at Home: Local Equity Preference in Domestic Portfolios, 59 J. Fin. 2045 (1999).

localized region, professional intermediaries may play a necessary role to build trust (or reduce informational asymmetries) beyond the geographic region in which the entrepreneur is personally known. The U.S. experience illustrates how underwriters could develop trust on a trans-Atlantic basis and serve as bonding agents in order to elicit foreign shareholder investment. This process was probably more visible in the U.S. because the U.S. was a capital-importing nation until after World War I and greater efforts were needed to attract foreign capital. To the European investor, the 19th Century railroad wars between rival American Robber Barons resembled the Wild West. Before the U.S. could successfully present itself as an attractive venue for European investors, special bonding measures were necessary. The House of Morgan initiated and perfected this process by placing its directors on corporate boards. Although U.S. law did little to ease the anxieties of foreign investors, U.S. intermediaries – both investment bankers and the New York Stock Exchange – filled this void.

In the transition to the next stage in which control blocks are diluted, an active merger market in both countries (but peaking at different times) appears to have hastened the transition to dispersed ownership by offering sellers a higher premium than they could expect to receive ordinarily from buyers in the secondary market. Because the U.S. merger wave of the 1890s essentially offered stockholders enhanced market power, it inherently promised them the equivalent of a control premium. Also, firms that did not join in the formation of such industry-wide oligopolies faced the risk of being excluded and thereby made worse off. Thus, there was an element of coercion in the break-up of U.S. blocks during this merger wave, just as the British tax laws later supplied an even clearer degree of coercion to induce control dilution.

British heightened merger activity in the 1950s and 1960s cannot be as easily explained. The conglomerate merger movement of this era no longer appears to have had a strong foundation in economic efficiency. Still, controlling shareholders of acquired firms already had tax-motivated reasons to sell and thus may have welcomed merger transactions at lower premiums than they otherwise would have demanded. The only practical alternative for blockholders seeking to avoid estate taxes was to sell into the secondary market on the LSE, where prices were also arguably inflated by the strong, but similarly tax-induced, demand for securities on the part of pension funds and insurance companies.

Nowhere in this story do the legal rules protecting minority shareholders play an important role. The most important protection accorded to U.K. minority shareholders during this period – i.e., the elimination of unequal voting rights – was the product not of mandatory law, but of voluntary action by acquiring firms in order to enable them to use their shares as merger currency.

Viewed through the prism of Roe's political theory, the dispersion of share ownership and the death of "family capitalism" in the U.K. did have a political cause (i.e., high tax rates and death duties that were imposed by a Socialist government seeking to redistribute wealth), but this impact on share ownership seems not to have been foreseen. For those on the Left, the breakup of family capitalism was an unintended, but probably serendipitous, result.

In both the U.S. and the U.K., private ordering and self-regulation played decisive roles. In the U.S., the House of Morgan and the NYSE developed bonding devices that made equity investments in the U.S. attractive to foreign investors. In the U.K., institutional investors quickly filled the void left by controlling shareholders and lobbied for practices (such as the Takeover Code) that significantly reduced the private benefits of control. In this light, the centrality of private ordering and industry "best practices" may give a continuing relevance to the work of LLS&V. Their efforts to prove the superiority of the common law to the civil law have encountered nearly unanimous skepticism from legal scholars. But, in their later re-interpretations, they have suggested that the specific elements of the common law that they find correlated with strong capital markets may be only proxies for deeper differences between the governance regimes of "common law" economies and "civil law" economies. Those deeper differences may include the greater receptivity (or at least tolerance) for private ordering and self-regulation. Capital markets began to develop in the U.K. and later in the U.S. during the 18th Century (and arose even earlier in The Netherlands). All three countries were pluralistic and relatively decentralized societies in which political and economic power were separated. In contrast, France and Germany were far more centralized states in which the governments sought to plan and channel economic growth and investment.[138] As a result, in the U.S. and the U.K., private ordering was given greater room in which to function, and this gave rise to self-regulatory institutions (such as the NYSE and LSE). These self-regulatory bodies were flexible and able to adapt relatively quickly to new circumstances. Viewed in this light, in the turn-of-the-century United States, J. Pierpont Morgan may have been the ultimate self-regulatory authority, relied upon by the markets to quell panics and by industries to establish a collusive peace and order.

---

[138] This author has elaborated on these differences at length elsewhere. See Coffee, supra note 26, at 59-64. In particular (as Roe has emphasized), the U.S. lacked a true central bank from the Administration of Andrew Jackson to that of Woodrow Wilson. Inherently, this precluded any effort at centralized economic planning and left greater space for private ordering.

To sum up, in the U.S. and the U.K., intermediaries and self-regulatory bodies played necessary and critical roles, both in establishing the institutional mechanisms necessary for creating trust and in regulating markets. They were able to do so because the political and legal environment gave them greater space in which to operate and did not directly control or supervise them. In this sense, LLS&V were correct to search for the fundamental differences in social and economic structures of different societies, and the decentralized political and economic structure within the U.S. and the U.K. may have been the critical variable that explains their convergence.

V. The Persistence of Passivity: Why Don't Institutional Investors Reunite Ownership and Control?

As retail shareownership has declined and institutional ownership has concentrated, the separation of ownership and control could end, as institutional investors reunite the two in the U.S. and the U.K. By the early 1990s, the 25 largest institutional investors in a U.K. public company had come to hold roughly one-half of its stock, while in the U.S. the corresponding figure would have been a roughly one-third ownership.[139] In principle, coalition formation is feasible in both countries, if somewhat easier in the U.K. In reality, the degree of concentration may be even higher, both because pension funds typically delegate decisions to an even more limited number of professional fund managers and because many (and possibly most) institutional investors rely upon a limited number of professional proxy advisers with regard to voting decisions.[140] Finally, proactive hedge funds have appeared whose basic business model involves searching for

[139] See Cheffins, supra note 27, at 371.
[140] RiskMetrics Group, Inc., which acquired Institutional Shareholder Services ("ISS") in 2007, is the best known of these firms and dominates the industry. Some controversy surrounds these proxy advisers because of their alleged conflicts of interest. See Thuy-Nga T. Vo, Rating Management Behavior and Ethics: A Proposal to Upgrade the Corporate Governance Rating Criteria, 34 J. Corp. L., 1, 4-5 (2008)/

opportunities to participate in corporate governance – apparently in the belief that by challenging management ("rattling the cage" in the vernacular), they can raise the stock price. Thus, numerous commentators have suggested that institutional investors could (or should) end the separation of ownership and control.[141]

Nonetheless, this pattern of concentrated institutional ownership has been in place for over two decades, and the basic tendency of institutional investors to remain passive has not changed dramatically.[142] What explains the persistence of passivity? Two basic answers can be given:

A. The Costs of Coalition Formation

Coalition formation among institutional owners is simpler and easier in the U.K., both because share ownership is more concentrated and because the typical institutional investor owns a larger stake in the equity market. As of the early 1990s, Prudential Corporation, the largest British insurer and also the largest British shareholder, owned some 3.5% of the British stock market.[143] Many other institutional investors owned slightly smaller amounts in the 1 to 2%, whereas the largest U.S. institutional investor then owned or managed less than 1.5% of the larger U.S. equity market.[144] Prudential estimated as of this time that it held some 900 U.K. stocks and held a 5% or greater stock in "probably 200 companies."[145] But it would seldom exceed a 10% stake.[146] Hence, even for the largest institution in a concentrated market, it is a safe estimate that assembling a

---

[141] Probably the first author to make this point was Adolf Berle, himself. See Adolf A. Berle, Jr., POWER WITHOUT PROPERTY: A New Development in American Political Ecnomoy at 56-59 and 75 (1959).
[142] For a similar assessment, see Cheffins, supra note 27, at 370-375.
[143] See Black and Coffee, supra note 43, at 2011.
[144] Id.
[145] Id. The interviews with all the U.K. institutions discussed in this article were conducted by this author.
[146] Id. It then held stakes of up to 14%.

majority voting block would require it to gain the support of probably over twenty additional institutions.[147]

Of course, this is costly, both in terms of out-of-pocket costs (such as legal fees) and diverted executive time. But there are at least three additional complications associated with coalition formation:

1. The "Race to the Exit" Scenario. Institutional investors in the U.K. have reported that attempts at coalition formation could backfire if those approached learn that a leading investor is dissatisfied. Because the implicit message is thus that a major investor is unhappy with management (and may therefore sell its stock unless changes are implemented), other investors face a dilemma: if the large (and usually "overweighted") investor organizing the coalition fails in achieving its purpose, it will likely reduce its holdings and drive down the stock price.[148] For the institutions so approached by it, the choice is whether to join the coalition or "race for the exit" and sell before the news becomes public. Moreover, because the process of organizing the coalition and then challenging management would take a number of months, it may be obvious that adverse publicity and a war of contending press releases will follow during which the corporate management's competence and/or integrity will be challenged. Because of this fear of an early "rush to the exit," some institutions reported that they would be careful in terms of the institutional investors they contacted to join a prospective coalition, thereby reducing the field of eligible coalition candidates.

[147] This estimate assumes that the original proponent held nearly 10% and needed to obtain an additional 40%.

[148] Id. at 2061-62. Other investors might also believe that the investor seeking to form this coalition had material adverse information that it was not willing to share. Id. at 2062.

This problem is probably less severe in the U.S. where the holdings of the institutional investor seeking to organize the coalition will typically be smaller (and probably under 5%). But, the more concentrated the institutional market, the greater the fear of a "race to the exit."

2. The Passivity of the "Underweighted." The normal expectation in the U.K. is that the institutional investor who organizes a coalition of investors to negotiate with management will be "overweighted" – that is, it will own a higher percentage of the company's stock than its overall share of the U.K. market.[149] Sometimes, such an "overweighted" investor has even been assigned the role of lead organizer by U.K. authorities.[150] Although it is not surprising that an investor with a large stake will be more motivated to challenge management than a small investor, the point here is subtler. One institution holding 1.0% of the U.K. market might be "overweighted" in a particular stock and own 2%; another investor might also own 2% and yet be "underweighted" because it owned 2.5% of the U.K. equity market. Only the first investor is perceived to be willing to take on the costs and effort of coalition formation.

Why? Because institutions are locked in a competition for investors' funds, which turns largely on their relative performance, none wants to help its competitors. Yet, an "underweighted" firm essentially does that when it bears expenses to change management or policies at a corporation in its portfolio; the result is to benefit its "overweighted" rivals in that firm more than itself. Thus, "underweighted" institutions tend to remain passive; they may vote with a coalition but not contribute to the costs of

[149] Id. at 2048 and 2063.
[150] Id. at 2043 (noting that Bank of England suggested that Norwich Union lead a shareholder battle as the most "overweighted" institutional investor).

collective action.[151] This likely passivity of "underweighted" institutions means again that only a limited number of institutions can be expected to lead or fund organized shareholder resistance.

3. The "Free Rider" Problem. Even when an institutional investor is willing to vote with an activist coalition of fellow shareholders, it does not follow that it will contribute to their common defense on a pro rata basis. In a well-known episode in the early 1990s, institutional investors organized and removed the board of Tace PLC.[152] This revolt was led by Norwich Union, an insurance company that held a 5% block in Tace and whose chief financial officer then chaired the Institutional Shareholders' Committee. Although the institutions succeeded in ousting the founder and chief executive officer of Tace, who held a 23% block, the victory was arguably a Pyrrhic one, because Norwich Union was forced to split a substantial legal bill with one other shareholder, as all the other institutions in the group declined to contribute.[153] Because Tace was a relatively small corporation, it is uncertain that this same coalition of investors would have been able to undertake a more costly campaign against a larger company.

More importantly, if other coalition members cannot be induced to contribute, then those organizing the coalition will rationally invest funds only if they believe that collective action will produce an expected benefit to the corporation or to its share price that, when divided by their percentage of stock ownership, equals their costs. That is, for a 5% shareholder to expend $1 million in costs, it would have to anticipate $20 million in

[151] Id. at 2064.
[152] Id. at 2042-43.
[153] Id. at 2043-2044.

gains to the corporation or its aggregate stock price.[154] This is a mathematics that will deter most activists most of the time.

B. <u>The Liquidity/Control Tradeoff</u>

The foregoing problems of coalition formation are mitigated if institutional investors hold larger stakes. Roe and others have argued that institutions would take such larger equity positions but for regulatory constraints that deter them. There is clearly some truth to this argument in the United States, where a variety of regulatory provisions do discourage institutions from holding large blocks.[155] Yet, although similar restrictive rules are not in force in the U.K., the same pattern persists.

The simple truth is that institutional investors are generally unwilling to sacrifice liquidity.[156] Thus, even in the absence of legal restrictions in the U.K., Prudential and other institutional investors reported themselves to be extremely "cautious" about exceeding the 10% level in any stock for fear of losing liquidity.[157] Small institutions may also fear a loss of diversification if they hold very large blocks, but the fear of illiquidity is common to most all institutional investors. Yet, if institutions feel compelled to hold less than 10% to preserve liquidity, the task of coalition formation is made more difficult – particularly when no mechanism exists to induce <u>pro</u> <u>rata</u> cost sharing among coalition members.

---

[154] It is possible that some institutions may believe that there is a general deterrent benefit from curbing managerial excesses that can benefit them, even if they do not directly recover their costs. Even if valid in theory, this view is not widely shared.

[155] The clearest example is Section 16(b) of the Securities Exchange Act of 1934, which denies any shareholder the ability to profit on a gain made (or a loss averted) on a purchase and sale (or sale and purchase) transactions that are within six months if the shareholder owns more than 10% of the publicly held company. This mandatory six month holding period creates illiquidity and forces most U.S. institutions to keep their ownership below the 10% level.

[156] For the fuller development of this argument, see Coffee, supra note 15.

[157] See Black and Coffee, supra note 43, at 2011.

To generalize, investors that want liquidity must surrender control.[158] As a result, a basic control/liquidity tradeoff arises. A few institutions (most notably, hedge funds) may be able to accept relative illiquidity and so are more able to participate in control, but others (such as mutual funds) find the need for liquidity to be paramount and so remain generally aloof from control and corporate governance disputes.

Although liquidity is the primary concern, other factors also constrain institutional activism. As noted earlier, a large indexed institution may own the securities of 900 or more corporations.[159] Neither pension funds nor mutual funds have the logistical capacity to monitor such portfolios in detail. To be sure, they can use professional money managers and can rely on proxy advisors with regard to voting issues. But mutual funds in particular need to economize on their costs to remain competitive, and this further constrains their monitoring capacity. To the extent that they do rely on outside consultants, they are likely to receive advice and voting instructions based on rules of thumb or industry best practices, and not an in depth, specific evaluation of a company's management. In any event, in interviews, institutional investors regularly stress that they are stock traders and portfolio managers, not management consultants.[160]

The claim here is not that institutional investors will never intervene (clearly, they have). Some (such as hedge funds) may be more proactive because they have accepted illiquidity and a lack of diversification as part of their business model. But such

---

[158] In the U.S., there are many legal restrictions (Section 16(b) of the Securities Exchange Act, insider trading rules, and the Williams Act) that backstop this generalization. Roe has covered these provisions at length. See Roe, supra note 17, at 151-168. But, even in the U.K., where the same legal restrictions are largely lacking, a control block is inherently illiquid, thereby forcing the same choice.
[159] This was the figure given by Prudential, and some U.S. institutions are both larger and more indexed. See Black and Coffee, supra note 43, at 2011.
[160] For such comments, see Id. at 2047-2048.

institutions will not be broadly marketed to most investors and so will not predominate. As a result, institutional passivity seems likely to remain an enduring characteristic of dispersed ownership systems.

To be sure, their level of passivity is not fixed and can be influenced by legal rules. The rise of hedge funds and recent regulatory reforms in the United States (most notably, "access to the proxy" statement[161]) may result in more challenges to incumbent managements. But these are differences of degree, not of kind.

In short, a reunification of ownership and control appears unlikely so long as dispersed ownership persists as the dominant structure of share ownership in a jurisdiction. This does not mean that dispersed ownership cannot be superceded. Canada supplies an example of a jurisdiction that has gone from a dominant system of concentrated family ownership to dispersed ownership and then back to family ownership – all within a half century.[162] But dispersed institutional owners seem likely for the foreseeable future to remain more distant and aloof from management decision-making than traditional controlling shareholders.

CONCLUSION

Inherently, scholarship involves a continuing debate between "lumpers" and "splitters." Academic glory normally goes to the lumpers, who generate grand theories by operating at a high level of abstraction. Yet, eventually the tide turns as too much inconsistent evidence turns up. The recent literature on global corporate governance has

---

[161] For a discussion of this and related proposals, which would allow institutions to economize greatly on the costs of a proxy contest, see J. Robert Brown, Jr., The SEC, Corporate Governance and Shareholder Access to the Board Room, 2008 Utah L. Rev. 1339.

[162] See Randall K. Morck, "The Rise and Fall of the Widely Held Firm: A History of Corporate Ownership in Canada," in Randall K. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD (2005) at 65-148.

been a heyday for lumpers, with provocative meta-theories advanced by a number of incisive theorists, most notably Roe and LLS&V. But gradually the "splitters" begin to re-assert themselves, dissecting and dismantling overbroad generalizations. That process is now well underway. Across a variety of jurisdictions, splitters are finding that strong legal rules protecting minority shareholders were not a precondition for dispersed ownership to arise. Instead, intermediaries could and did structure private ordering mechanisms that protected minority shareholders.

This conclusion should not surprise. Studies of contemporary emerging markets also find that, particularly in countries with weak legal protections, firms with higher corporate governance and transparency rankings are valued higher in the stock market.[163] To be sure, not all firms will seek to bond themselves in this fashion (because the private benefits of control may often be more valuable). Thus, the availability of such private mechanisms do not alone induce the widespread breakup of control blocks. Rather, the fuller history of dispersed ownership must recognize the role of historical contingencies (merger waves in the U.S. and tax laws in the U.K.). Nonetheless, the fact the U.S. and the U.K. did converge on a similar pattern of share ownership was neither because of their "common law" roots nor similar political histories. The most that can be said is that both countries encouraged and accepted private ordering and self-regulation.

By no means do these conclusions imply that there is little role for theory. Similarities between the political economies of the U.S. and the U.K. – most notably their decentralized governance, their separation of political and economic power, and their preference for private ordering – do stand out and may have played a significant role in

[163] Art Durney and E. Han Kim, To Steal or Not to Steal: Firm Attributes, Legal Environment and Valuation, 50 J. Fin. 1461 (2005).

the rise of dispersed ownership. Further modeling is thus needed of the relationship between political economies and financial markets. Finally, because firms with dispersed ownership are known in all markets, their ubiquity seems to imply that private ordering can create enduring, stable firms in which ownership and control are separated in virtually any legal or political environment. To be sure, such mechanisms are used only sporadically. But precisely because entrepreneurs only sometimes seek to maximize share value through such arrangements, that is the phenomenon (not mandatory legal rules) that most merits future study.

Financial assistance for the services of the editorial assistant of these series is provided by the European Commission through its RTN Programme on European Corporate Governance Training Network (Contract no. MRTN-CT-2004-504799).

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (www.ecgi.org/wp) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html