

The Berle-Means Corporation in the 21st Century

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I. Introduction

Ever since Berle and Means' revelation about the extent to which ownership of shares of large US corporations was dispersed,¹ scholars of corporate law have debated the desirability of this pattern. A simple economic rationalization is that as the scale of industrial enterprise—and its associated capital requirements—grows, a point is reached at which the reduction in risk-bearing and liquidity costs achieved by dispersed ownership more than offsets the consequent increase in managerial agency costs.² Whilst this rationalization is framed at the level of the firm, the apparent ubiquity of dispersed ownership in the US lead many scholars to extrapolate that there were deterministic, or 'natural', relationships between the dispersion of stock ownership, the structure of corporate law, and economic development.

This latter view was challenged by evidence from other jurisdictions, made available in robust form in the 1990s, that dispersed stock ownership was not the norm internationally. Two stylized facts emerged. First, every jurisdiction has at least a few firms that have dispersed stock ownership.³ Consistently with the risk-bearing story, these tend to be amongst the largest firms. However, the aggregate number of such firms, and their significance as a proportion of market

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¹ ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

² Easterbrook and Fischel.

³ Conversely, in no jurisdiction do *all* publicly-traded firms have dispersed stock ownership. A recent study reports that even in the US, ownership of mid-sized publicly-traded firms may be far more concentrated than has previously been appreciated: see Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, working paper, Boston College (2006), forthcoming *Rev. Fin. Stud.*

capitalization, vary widely across jurisdictions. Secondly, in only a few jurisdictions—most clearly the US and the UK—is it the case that this pattern of ownership predominates amongst the largest publicly-traded companies.

These observations may plausibly be interpreted as follows. On the one hand, the trade-off between risk-bearing and agency costs may depend on a range of firm or industry-specific factors other than simply size of capital aggregation, such as financial versus human capital intensiveness, propensity to innovate, and level of competitiveness in the industry. Thus not all firms might be expected to move towards dispersed stock ownership: rather, a mixed equilibrium in which some are dispersed and some remain concentrated, might be expected. On the other hand, various aspects of the regulatory environment may bias the development of national systems either in favor or against a norm of dispersed ownership, leading to a starker division between ‘systems’ than firm-level optimization might alone dictate. Lack of effective restrictions on controlling shareholders’ ability to derive private benefits may plausibly act as a constraint on the unwinding of control structures.⁴ Equally plausibly, tax and regulatory requirements may—intentionally or otherwise—create a push towards dispersed ownership in a more comprehensive fashion than purely firm-level cost considerations might otherwise dictate. Moreover, established ownership patterns feed into political economy, likely reinforcing path dependencies. These factors all point to potential disconnect between firm-level efficiency concerns and systemic ownership patterns: what we term the ‘systemic’ view of comparative corporate governance.

The evolution of both ownership structure and corporate law in the UK and US is consistent with these observations. In both countries, the development of dispersed ownership appears to have occurred for contingent reasons, as a likely-unforeseen corollary of policies designed to achieve other goals. The origins of the US system lie in populist hostility towards financial institutions.⁵ By the 1930s, retail shareholding was already a large-scale phenomenon,⁶ meaning that there was widespread political support for the New Deal legislation, a system designed around the retail investor in the Berle-Means corporation, and which helped to maintain the viability of dispersed stock ownership. In Britain, from the 1950s onwards, a powerful tax

⁴ Lucian Ayre Bebchuk and Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 *Stanf. L. Rev.* 127 (1999).

⁵ MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994).

⁶ John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control*, 111 *Yale L.J.* 1 (2001).

bias lead individual investors to sell and institutional investors to buy shares,⁷ with the result that by the mid-1970s, the majority of shares in domestic UK listed companies were owned by domestic institutions. Once established as significant players, these institutions became active and effective participants in the development of publicly-traded corporations' regulatory regime.

Moreover, despite the fundamental similarity of the basic problem of corporate governance in the UK and US—namely, the control of managerial agency costs—the mechanisms deployed in response to this problem are quite different. These complement differences in the median investor. The US approach, which may be characterized as 'law-oriented', uses the retail investor as its regulatory heuristic. Facing high co-ordination costs, retail investors are passive and ill-informed contributors to corporate governance. Three key features of the regime flow from this. First, extensive disclosure obligations are imposed by federal securities laws, with the intention of bridging the information gap between firms and shareholders and harnessing market pricing to overcome investors' coordination costs. Secondly, there is a concentration of power in the board, and concomitantly limited set of control rights for shareholders, which may be rationalized as an efficient division of labor when investors are numerous, highly dispersed, and ill-informed. Thirdly, there is aggressive court enforcement of rules regulating self-dealing transactions and mandating disclosure.

In contrast, the UK's approach, which may be termed 'governance-oriented,' has primarily been focused on the provision of control rights to institutional investors. As compared to retail investors, institutions are relatively sophisticated, have lower co-ordination costs and are more active participants in corporate governance. Compared with the US, there is consequently greater control in the hands of shareholders, over matters such as requisitioning meetings, removing directors, controlling defensive tactics during hostile takeovers, and veto rights for self-dealing. In contrast, there has traditionally been far less emphasis on issuer disclosure and judicial regulation of self-dealing, with court enforcement rates being much lower. Instead, greater emphasis has been placed on reputational enforcement mechanisms, consistently with the higher potential for repeated interaction amongst a relatively small community of significant investors.

As the twenty-first century begins to unfold, the autonomy of country-level 'systems' of corporate governance is likely to be challenged to some degree by the increasing globalization of international capital and product markets. *Firms* have new opportunities to reincorporate or cross-list in other jurisdictions, allowing them to opt into legal and institutional frameworks based

⁷ LESLIE HANNAH, *THE RISE OF THE CORPORATE ECONOMY: THE BRITISH EXPERIENCE* (1976); BRIAN R. CHEFFINS, *CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED* (2008).

around dispersed stock ownership, even when the nation(s) in which their physical plant is located lack such institutions. Large institutional *investors*—be they ‘traditional’ pension funds and mutual funds, or ‘new’ private equity, hedge and sovereign wealth funds—are increasingly investing across borders. These processes at once disturb ruts in domestic political economy and stimulate firms to explore other regimes.⁸

Our concern here is with the likely configuration of mechanisms that will be deployed in controlling agency costs in firms with dispersed ownership: that is, the ‘Berle-Means Corporation’ in the 21st Century. In the short run, such firms are more likely than not to be based in the UK or US. Ownership patterns in these two jurisdictions have changed—and converged—quite dramatically since the early 1990s. Institutional investors have become the dominant owners of US stocks. These are not the cohesive, clubby, domestic institutions of 1980s London, however. Rather, they are a much more eclectic and international mix of passive funds, activist investors, private equity and sovereign wealth funds. Strikingly, this same mix of international, heterogeneous and uncohesive institutions has also come to predominate in the UK.

This means that neither the U.S. nor the U.K.’s traditional regulatory patterns will work as well in the future. The U.S. model constrains too sharply the possibilities of shareholder governance and thus substitutes higher cost mechanisms (like hard-to-calibrate high-powered incentives) to constrain managerial agency costs. There has been insufficient disclosure of ownership interest and activity by substantial shareholders despite newly-developing ways to synthesize voting influence and economic participation. The U.K. model, on the other hand, lacks sufficient private and public enforcement capabilities. As institutional owners become more diverse and international, reputation effects will work much less well to constrain opportunistic behavior vis-à-vis other institutions in governance cooperation. Regulators will have diminished capacity to identify, understand, and address in “light touch” ways patterns of concerning behavior.

We discuss briefly some of the regulatory patterns that would fit better with the governance needs of the metropolitan firm and the possibilities of regulatory convergence. What are the hallmarks of the regulatory system that may emerge? Turning to our hazy crystal ball, it seems that such firms ought to be subject to extensive, and credibly enforced, disclosure

⁸ For example, private equity investors can help to break down the firm-level path dependencies that might previously have hindered companies from taking up such opportunities, as they have incentives to select a jurisdiction for listing, when they exit, which will maximize the value of the firm. See John Armour, *Who Should Make Corporate Law? EC Legislation versus Regulatory Competition*, 58 *Curr. Leg. Prob.* 369, 391 n97 (2005).

regulation (above the historical level in the UK); at the same time they will also likely to find their managers being held on a short governance leash by institutional investors (that is, with stronger governance entitlements than are currently granted to US shareholders). Moreover, their (more-empowered) shareholders will find themselves subject to increasing disclosure obligations designed to mitigate intra-shareholder opportunism problems and a developing code of practices that would be unacceptable.

A second implication concerns the growing influence of heterogeneous institutions on the political economy of regulatory structures. There are, we consider, reasons to be circumspect about the functionality of institutional shareholder-driven regulation. Institutional investors are subject to agency costs of their own, and their track record indicates they are susceptible to problems of herding and overinvestment in particular asset classes. There is no reason to believe that these weaknesses will not translate into herding as regards corporate governance reform.

In the medium term, it may be that a class of ‘metropolitan corporations’ emerges: organized on the Berle-Means pattern, with dispersed stock ownership and a listing and/or incorporation in the jurisdiction that provides the most favorable governance regime.⁹ We should not imagine that all such ‘metropolitan corporations’ will end up gravitating, legally, to the US or the UK: other countries will likely adopt aspects of the regulatory regimes observed in these two.¹⁰ Nor, indeed, do we claim that dispersed shareholder ownership will be predominant amongst publicly-traded corporations worldwide: both blockholders and dispersed owners can be accommodated efficiently through domestic regulatory menus. Rather, it is our contention that understanding the trajectory of governance mechanisms in the UK and US will provide insights into what the governance regimes applicable to such firms will look like.

The rest of the paper is structured as follows. Section II reviews our understanding of the incidence of, and explanations for, the ‘Berle-Means corporation’. Section III describes two varieties of dispersed ownership and associated governance mechanisms: “cohesive institutional/governance-oriented” in the UK and “retail/law-oriented” in the US. Section IV

⁹ We do not mean to imply that there will be an inexorable global trend towards this form of organisation: rather that simply *for some firms* whose physical and current legal location is outside the UK and the US, this is likely to prove an attractive option. At the same time, private equity firms can also act to concentrate the ownership of domestic firms in these jurisdictions for which dispersed stock ownership is not appropriate, with the most valuable exit under such circumstances being a secondary or tertiary sale: see Brian R. Cheffins & John Armour, *The Eclipse of Private Equity*, 33 Del. J. Corp. L. 1 (2008).

¹⁰ The evolution of takeover regulation in Japan, a country which has moved toward more dispersed stock ownership in recent years, is a case in point: see Curtis Milhaupt, *In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan*, 105 Colum. L. Rev. 2171 (2005).

describes the emergence of “uncohesive institutional” ownership in both the US and UK, and explores its likely implications for governance mechanisms. Section V concludes.

II. The Berle-Means Corporation in Comparative Context

1. The ‘Berle-Means Corporation’

In 1932, *The Modern Corporation and Private Property* heralded the arrival of managerial capitalism in the US.¹¹ It made the groundbreaking observation that the ‘ownership’ of large US corporations had become separated from their control. The authors’ pioneering empirical research showed that in many large American corporations, there was no single shareholder—or even group of shareholders—who owned a sufficient percentage of the shares as to be characterized as ‘controlling’ the firm. In such firms, the authors reasoned, the effective locus of control in fact lay with the directors, and their hired managers, to whom the shareholders as a collective had notionally delegated the power to run the firm. Since then, the authors’ names have come to be associated with the phenomenon to which they drew attention: corporations in which no single stockholder or group of stockholders holds a sufficiently large stake as to exercise meaningful control over the managers’ conduct.

Berle and Means did not view the separation of ownership and control as a benign development. For them, it heralded the rise of a ‘managerialist’ form of capitalism, under which vast resources were marshaled at the hands of a few corporate managers, unchecked by due political process. This perspective was echoed in the work of many scholars writing over the next 40 years.¹² However, in the 1970s, economists began to rationalize dispersed equity ownership as involving a tradeoff between the costs of managerial agency—the principal object of concern for Berle and Means—and economies in risk-bearing.¹³ Widely dispersed shareholders are able better to diversify their risk-bearing, and so permit firms to lower the risk-bearing component of their cost of equity capital. However, this came at the price of a lowering in shareholders’ ability to coordinate and monitor managers. The central goal of corporate law was on this view seen as the amelioration of the agency costs to which this gave rise. For many US scholars at this time, the

¹¹ BERLE & MEANS, *supra* note 1.

¹² Refs e.g. Galbraith

¹³ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, ___-___ (1976); FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991), 40-72.

separation of ownership and control was viewed as the result of economic determinism—a trade-off, to be sure, but one that was presumptively optimal owing to its universal acceptance.

This perception was shaken by evidence from other countries, which came to be available in robust form only by the early 1990s. A series of international studies exploded the myth of the universality of the Berle-Means corporation.¹⁴ On the contrary, it appeared that dispersed stock ownership was in fact the exception, rather than the norm, internationally. This was at a time in which German and Japanese companies were perceived to be outperforming their US counterparts, leading some to ask whether, in addition to being distinctive, dispersed ownership was also a competitive disadvantage. At the same time, the LBO boom of the 1980s posed a clear challenge to the domestic ubiquity of the dispersed ownership paradigm. Many former public companies were purchased by private equity bidders, thereby transforming them from dispersed to concentrated ownership, leading some to argue that private equity's superior ability to control managerial agency costs lent it outright economic advantages.¹⁵ Explanations for the Berle-Means corporation's success in the US were sought not in economic determinism, but in the contingencies of domestic politics.¹⁶

But by the end of the 1990s, the pendulum had swung back again. The American economy was booming, and doubts about the economic utility of diffuse ownership disappeared. Some argued that the march of globalization would force other countries to open up their domestic product and capital markets to forces of competition in a way that would render the competitive weaknesses of their systems of corporate governance all too apparent.¹⁷ Comparative discussion shifted from how the US had been held back in developing diffuse ownership, to how other jurisdictions had been held back in failing to do so.¹⁸ Others, however, were content to remain agnostic as to the economic (dis)advantages of one form of ownership or the other.¹⁹

¹⁴ See, e.g., Julian Franks and Colin Mayer, *Capital Markets and Corporate Control: A Study of France, Germany and the UK*, __ Econ. Policy 189 (1990).

¹⁵ Michael C. Jensen, *The Eclipse of the Public Corporation*, 67 Harv. Bus. Rev. 61 (1989).

¹⁶ Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 250 (1990); ROE, *supra* note **Error! Bookmark not defined.**

¹⁷ See Henry B. Hansmann and Reinier A. Kraakman, *The End of History for Corporate Law*, Geo. L.J. (2000).

¹⁸ See La Porta et al (1997); Bebchuk (1999); Rene M. Stulz, *The Limits of Financial Globalization*, 60 J. Fin. 1595, ___-___.

¹⁹ See Carlin and Mayer (2000).

2. How Prevalent is Dispersed Stock Ownership?

The exact incidence of ownership patterns according with the Berle-Means paradigm, both at different points in time, and across countries, is controversial. Quite apart from the considerable difficulties of data availability and comparability, the issue is complicated by the fluidity of the notion of ‘effective control’, the application of which is likely to be highly context-specific. As a result, a range of different indicators of ownership dispersal in publicly-traded firms have been employed in the literature—as they were by Berle and Means themselves.²⁰

One of the most influential studies, that of La Porta, Lopes-de-Silanes, and Shleifer in 1999, focuses on the 20 publicly-traded companies with the largest market capitalization at the end of 1995, in each of 27 developed countries.²¹ The results show that, around the world, the UK, Japan, and US, followed by Australia, Ireland, and Switzerland, have the highest proportion of such firms without a 20% blockholder.²² However, when a more restrictive test, reporting the proportion of the 20 largest firms not having a 10% blockholder, is applied, the UK and US are clear international outliers.²³ Another study by Faccio and Lang, investigating the ultimate ownership of all publicly-traded Western European corporations, reported that the UK and Ireland had far fewer firms with 20% blockholders than was the case in any other jurisdiction sampled.²⁴ Similar results emerge from the ECGI’s *Control of Corporate Europe* project, which collated data on blockholdings required to be disclosed in the EU and US for all publicly-traded companies.²⁵ The median largest voting block reported in UK companies was a 9.9% stake; this

²⁰ See discussion in BERLE & MEANS, *supra* note 11, ___-___; MARK J. ROE, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE* (2003), ___-___; PETER A. GOUREVITCH & JAMES J. SHINN, *POLITICAL POWER AND CORPORATE CONTROL: THE NEW GLOBAL POLITICS OF CORPORATE GOVERNANCE* (2005), 17-20;

²¹ Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. Fin. 471 (1999).

²² *Ibid.*, 492 (Proportions of the largest 20 firms reported as not having a 20% blockholder are: UK: 100%, Japan 90%, US 80%, Australia 65%, Ireland 65%, Switzerland 60%; average for sample countries: 36%).

²³ *Ibid.*, 493. See Table 1, *infra*. See also Stijn Claessens, Simeon Djankov, and Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. Fin. Econ. 81, 103 (2000) (Japan had far greater proportion of firms with widely dispersed ownership in 1996, whether measured by absence of 20% or 10% blockholder, than other East Asian countries).

²⁴ Mara Faccio and Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. Fin. Econ. 365, 379-380 (2002).

²⁵ FABRIZIO BARCA & MARCO BECHT (EDS.), *THE CONTROL OF CORPORATE EUROPE* (2001).

was less than half the size of the next smallest European median, 20%, in France, and less than a quarter of the size in many European countries.²⁶ By comparison, the median largest voting block for NYSE listed firms was 5.4%, and 8.6% for NASDAQ.²⁷

A somewhat more nuanced finding is reported by Holderness in a recent study.²⁸ He compiles a representative sample of all publicly-traded US firms, and then compares this with firm-level data (all from 1995) from other jurisdictions, controlling for size, age, and industry. Once these factors are taken into account, the US is no longer an international outlier. Rather, as measured by the incidence of blockholding, and the size of blocks, approximately one-third of a sample of 22 developed and developing countries have more dispersed ownership in publicly-traded firms than the US.²⁹ The UK and Japan are clear outliers with the most dispersed ownership in Holderness' results.³⁰ The disparity between these findings and the earlier studies may stem from the fact that dispersion increases with firm size.³¹ The US has the world's largest economy, the largest stock market capitalization, and the largest number of publicly-traded firms (see Table 1). It is highly plausible that, towards the top end of the size distribution of US listed firms, there are more publicly-traded firms with diffuse ownership than anywhere else.

[Table 1 about here]

To summarize this section, the share ownership of the largest UK and US firms is more dispersed than in most other venues for listing worldwide. If we shift our attention from the largest firms to the population of listed firms as a whole, the US is no longer an international outlier, but the UK and Japan are. However, the US (and to a lesser extent, the UK and Japan) has a far larger stock market capitalization and population of listed firms than elsewhere. As larger firms are more likely to have more dispersed ownership, the foregoing implies that the largest

²⁶ Marco Becht and Colin Mayer, *Introduction*, in BARCA & BECHT (EDS.), *supra* note 25, ___-___. The study does not, however, report findings for Ireland.

²⁷ *Ibid.*

²⁸ Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, working paper, Boston College (2006), forthcoming *Rev. Fin. Stud.*

²⁹ *Ibid.*, 44 (Table 4).

³⁰ *Ibid.*, 43 (Figure 2), 44 (Table 4).

³¹ *Ibid.*, 19. On the link between size and ownership dispersion, see Harold Demsetz and Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 *J. Pol. Econ.* 1155, ___-___ (1985).

part of the world's population of 'Berle-Means corporations' is likely to be found in the US and the UK, [and, to a lesser extent, Japan].

4. What Causes Stock Ownership to be Dispersed or Concentrated?

The realization in the early 1990s that dispersed ownership was not the international norm heralded the start of a still-ongoing program of research directed towards explaining the different patterns of stock ownership worldwide. Whilst the comparative evidence means simple economic determinism is no longer convincing, more subtle economic accounts have been offered to explain the pattern. Just as size affects ownership structure, it is plausible that industrial and technological concerns may also be salient factors. We might term this the 'Coasean' view.³² Dispersed equity finance is plausibly better suited to the exploitation of emergent technologies, in regard to which continuation or liquidation decisions must be made rapidly.³³ On the other hand, a blockholder ownership structure may offer advantages for production in which employees must be persuaded to make firm-specific human capital investments, as a blockholder owner can commit more credibly to implicit or explicit contracts with employees regarding future returns on these investments.³⁴ Moreover, less reliance on equity markets invites greater reliance on bank finance, which also may have comparative advantages in relation to industries which employ relatively high levels of physical assets, rendering debt finance a suitable investment strategy.³⁵

The Coasean account is, however, rendered less plausible by the apparent global bias towards concentrated ownership. A complementary economic explanation points to path dependencies in this ownership structure.³⁶ [explain benign path dependency theory as well] Concentrated blockholders derive many rents from their controlling positions. If they sold their shares to dispersed owners, no shareholders would be able to capture such rents, and the blockholders would not be fully compensated for their loss of benefits. Thus we might expect a pronounced reluctance to sell on the part of blockholders. This would occur even if it were

³² See GOUREVITCH & SHINN, *supra* note xx, 30-37.

³³ See Carline and Mayer (2000). It may also be more attractive for entrepreneurs seeking venture capital finance *ex ante*, as dispersed ownership means that, after an IPO, they may regain control of their firm: Black and Gilson 1998 JFE.

³⁴ Carlin and Mayer, *ibid.*; PETER A. HALL & DAVID SOSKICE (EDS.), *VARIETIES OF CAPITALISM* (2001).

³⁵ See Franklin Allen, Laura Bartiloro, and Oskar Kowalewski, *Does Economic Structure Determine Financial Structure?*, working paper, Wharton Business School (2006).

³⁶ Bebchuk and Roe, *supra* note 4.

socially inefficient for control to be concentrated. Thus the economic theories suggest that, on the one hand, diversity in ownership structures may complement industrial structure, but on the other hand, there may be a bias towards blockholding brought on by path dependencies.

A second type of explanation for variance, focusing on the role of regulation, has been even more prominent in the literature. Broadly speaking, the claims in this tradition assert that the differing incidence of Berle-Means corporations across jurisdictions is associated with differences in the legal regulation of corporate governance. Within the regulatory perspective, there are strong differences over (i) the *scope* of relevant regulation—which legal rules are thought to be of significance in determining ownership structure; and (ii) whether law is *endogenous*—that is, whether law is a cause of dispersed ownership, or a symptom of something else.

On the one hand, La Porta, Lopes-de-Silanes, Shleifer, and Vishny report that the degree of dispersion of ownership amongst the largest firms in countries around the world is correlated with the degree of protection of outside investors from expropriation by managers.³⁷ They reason that ‘weak’ shareholder protection is associated with reduced willingness to invest money in the hands of managers. Moreover, they argue that the strength of shareholder protection is correlated with ‘legal origins’—namely, the civil or common law derivation of a legal system. This is thought to determine, exogenously, the content of the shareholder protection laws that in turn drive ownership structure. However, this position has been substantially undermined by historical case studies showing that ownership dispersal preceded shareholder-friendly regulation in both the UK and US,³⁸ and by new studies demonstrating that the correlations are not robust across different periods of time or measurements of legal protection,³⁹ and may even be an artifact of coding error.⁴⁰ [Enforcement?]

A second, ‘political’, line of argument also focuses on regulation, but views this as the product of political forces that also shape corporate governance.⁴¹ A key feature of a generalized political account is that regulation is both endogenous and path-dependent.⁴² That is, regulation to some degree reflects the political agenda, which may in turn be affected by the distribution of

³⁷ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. Fin. 1131 (1997).

³⁸ Cheffins (2001); Coffee (2001).

³⁹ Jackson and Roe (2006); Armour *et al* (2007).

⁴⁰ Spamann (2006).

⁴¹ The pioneer of this view was Mark Roe: see ROE, *supra* note xx; ROE, *supra* note xx.

⁴² GOUREVITCH & SHINN, *supra* note xx, 57-59; [Rajan and Zingales; Bebchuk et al].

surplus under existing regulatory structures. This, however, leaves important questions unanswered. If the separation of ownership from control precedes regulatory measures that cement it, how does it come about?⁴³

In order to shed light on these regulatory theories, we turn now to an examination of the US and UK, the jurisdictions in which, as we have seen, the Berle-Means corporation is most prevalent. In Section III, we examine the question of the *scope* of the relevant regulation that responds to the problem of managerial agency costs in each jurisdiction.

III. Two Varieties of Dispersed Ownership

1. Regulatory vs. Governance Mechanisms and Shareholder Types

The UK and US are, as we have seen, the two jurisdictions in which stock ownership in listed firms is most widely dispersed. This dispersal means that a fundamental concern for corporate law is the amelioration of managerial agency costs. These are the costs of separation between managers exercising control over the firm's decision-making, and shareholders who are in receipt of the residual returns from the carrying on of the business activities.⁴⁴ Broadly speaking, we may divide the law's responses to these costs into *regulatory* and *governance* mechanisms.⁴⁵ Regulatory mechanisms subject managers to legal constraints on their scope for self-interested behavior. Governance mechanisms, on the other hand, exert control over managers through the terms of their relationship with the firm and its shareholders—most obviously, by giving decision-making power to shareholders in certain circumstances.

To work effectively, each of these varieties of control mechanisms requires enforcement. In the case of regulatory mechanisms, this will involve a third-party agency, usually a court or regulator, to assess managerial conduct. In the case of governance mechanisms, the assessment is made not by an external agency, but by the shareholders, or in some instances independent directors appointed to act on their behalf. This is sometimes referred to as a difference between

⁴³ See Cheffins, *supra* note xx, xxx; Marco Becht and J. Bradford DeLong, *Why Has There Been So Little Block Holding in America?*, in RANDALL K. MORCK (ED.), *A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD*, 613, 618-620 (2005).

⁴⁴ Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305., ___-___; see also FRANK H. EASTERBROOK AND DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991), 171-174.

⁴⁵ See REINIER KRAAKMAN *ET AL.*, *THE ANATOMY OF CORPORATE LAW*, 2ND ED. (2009), 38 (distinguishing 'regulatory' and 'governance' strategies).

‘third-party’ and ‘second-party’ enforcement.⁴⁶ In the language of incomplete contracts theory, it relates to the difference between court enforcement of a contract, and reliance on property rights to structure a renegotiation. The label attached matters less than the point that the different types of control mechanisms are axiomatically associated with different types of enforcer.

It is important not to overstate the extent to which governance mechanisms may substitute for regulatory mechanisms. We do not mean to say that a system that relies on governance mechanisms need have no recourse at all to third-party dispute resolution. The point is rather that such recourse can be much more limited. Where governance mechanisms are used, courts need only decide questions of the allocation of decisional rights, and need not concern themselves with substantive issues. This corresponds to the ‘property rights’ view of the firm in economic theory, in which (legal) allocation of entitlement to control physical assets is used as a means of generating bargaining power in renegotiations between contracting parties.⁴⁷ All third-party decision-makers need do is to specify the circumstances under which one party or other has control of the assets; the substantive content of contract renegotiation is a matter for the parties.

There are characteristic differences in the necessary conditions for success when relying on each of these two types of enforcer. The first such difference concerns information requirements. Third-party enforcement requires that the information upon which an enforcement action is taken be independently *verified* to the decision-maker, whereas second-party enforcement requires only that it be *observable* to the party with the decision rights. The second concerns the incentives of the enforcer. Third-party enforcers typically have no financial stake in the outcome, whereas shareholders do. This might be thought to give the shareholders more high-powered incentives. However, this interacts with the third dimension, which encompasses collective decision-making. Where shareholders are numerous and dispersed, they will be less effective at monitoring (because of free-rider problems) and decision-making regarding enforcement. It also intersects a fourth issue, which is the risk of intra-shareholder opportunism. Powerful shareholder governance entitlements bring with them the concern that one group of shareholders may hijack the decision-making agenda to their private benefit, and to the detriment of others. Third-party enforcers are unlikely to pose such a risk.

⁴⁶ See, e.g., ROBERT ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBOURS SETTLE DISPUTES* (1991).

⁴⁷ See OLIVER HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* (1995), ___-___; Edward B. Rock and Michael L. Wachter, *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, 149 U. Pa. L. Rev. 1619 (2001).

In the corporate governance systems of most developed nations around the world, governance mechanisms are probably more significant in controlling managerial agency costs than are regulatory mechanisms. As we have seen, in most countries, the stock ownership of most major corporations tends to be concentrated in the hands of one or more controlling blockholders. Such a shareholder is well-positioned to appoint and control the managers, using governance rights.⁴⁸ Conversely, many commentators have tended to assume that if a company's stock ownership is widely dispersed, as described by Berle and Means, then governance mechanisms are less effective at controlling managers, because of the information and decision-making constraints with which shareholders will have to contend in exercising their entitlements. On this view, whilst governance may work for controlling shareholders, dispersed shareholders, being passive, need something else—likely regulatory mechanisms—to help them control managers.

In our view, a simple binary categorization is probably too stark. It does not necessarily follow that in the absence of a controlling shareholder, governance mechanisms cannot be more effective than regulatory strategies.⁴⁹ Rather, much may depend on the degree of dispersion and the identity of the shareholders. In particular, we might imagine that if shareholders are predominantly *retail* investors, then they are likely to hold very small individual stakes, thus rendering overall ownership highly diffuse, and also to lack the coordination and sophistication necessary to make effective governance decisions. On the other hand, if shareholders are predominantly *institutional* investors, then we might expect them (as compared to retail investors) to hold larger stakes in the firms in which they invest, to be more sophisticated, and better able to co-ordinate with one another. In short, institutional investors may be able to use governance mechanisms to control managers even in the absence of a controlling shareholder. Thus the absence of a controlling blockholder need not necessarily imply a turn to regulatory mechanisms to control managers. We might predict that a system in which institutional shareholders predominate would, *ceteris paribus*, be associated with less regulatory, and more governance, mechanisms than a system in which retail investors predominate.

This is not the only dimension across which we would expect to see differences. A second concerns the differing informational requirements of regulatory and governance mechanisms. Recall that governance mechanisms work on the basis of observable information. If

⁴⁸ Indeed, under these circumstances, the concern is not so much that the managers may take actions that are contrary to the interests of the shareholders as a whole, but rather that the controlling shareholder may procure the managers to take steps that are contrary to the interests of other shareholders.

⁴⁹ We do not imply here that either type of mechanism will operate perfectly: rather, we are engaged in an exercise of comparative efficiency between second- or third-best solutions.

institutional shareholders are able to observe poor managerial performance, then they can control managers by the threat of removal very effectively, without needing to verify this to an external agency. No-one other than the sophisticated shareholder—or coalition of shareholders—and the manager need be aware of the information. On the other hand, regulatory mechanisms have greater informational demands, because outcomes must be verified to a third party. The upshot is that we would expect greater reliance on regulatory mechanisms to be associated with greater information disclosure obligations imposed upon firms and managers.

We would also predict a third dimension of difference between retail and institutional systems. Whilst institutions may be better able to exercise governance rights than retail investors because of their lower decision-making costs, more powerful shareholders bring with them a greater risk of intra-shareholder opportunism. That is, a concern that one group of shareholders may form a coalition to expropriate minority investors. Thus a system relying on governance by powerful (institutional) shareholders may need to respond more effectively to concerns of intra-shareholder conflict.

Finally, it is worth observing that reputational constraints are likely to do more work in a system based on governance than one based on regulatory mechanisms. Governance mechanisms work better, we have suggested, in the hands of institutional investors, and are likely to be associated with lower formal disclosure obligations. Institutional shareholders are more likely to interact with one another on a repeated basis, so giving rise to the possibility of meaningful reputational sanctions (e.g. for intra-shareholder opportunism), than are retail investors.⁵⁰ In particular, if regulatory mechanisms are not developed to respond to managerial agency costs, then they may not readily be available to respond to intra-shareholder opportunism, and in this context, reputational constraints may have to do the work.

[Table 2 about here]

A comparison between the US and the UK systems of corporate governance helps to illustrate each of these points. As we have seen, both have strongly dispersed share ownership, as compared to the rest of the world. Yet until quite recently, a much greater proportion of outstanding shares in UK publicly-traded companies have been in the hands of institutional investors, than in the US. Correspondingly, US levels of retail ownership have been much higher.

⁵⁰ See Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 Colum. L. Rev. 2328 (2004).

This corresponds to differences in the mechanisms employed to control managerial agency costs, along each of the dimensions we discussed above. Table 2 summarizes these points, which the rest of this section will elaborate in more detail.

2. Predominant Shareholder Types

It is well-known that institutional share ownership has been growing rapidly in the US in recent years. However, in the UK, levels of institutional ownership have been far higher for far longer. This point is illustrated clearly in Figures 1 and 2, which use official data to show the changes in levels of institutional, versus individual, ownership in the two countries over time.

[Figure 1 about here]

[Figure 2 about here]

3. Shareholder Governance Mechanisms in the UK

Consistent with our account, shareholders in UK companies have greater governance entitlements than do their counterparts in the US. Here we offer a brief overview of those which we consider to be most salient in controlling UK managers.

1. Board Vulnerability

It is a mandatory rule of UK company law that an ordinary resolution—that is, a simple majority of those shareholders present and voting—of the general meeting is able to remove directors at any time.⁵¹ This negates the effect of ‘staggered board’ provisions, commonly used by US managers to entrench themselves against the possibility of shareholder removal.⁵² Default rules of

⁵¹ Companies Act 2006 § 168(1). However, it appears that rates of CEO turnover are only slightly higher overall in the UK than the US: see Mark L. Defond and Mingyi Hung, *Investor Protection and Corporate Governance: Evidence from Worldwide CEO Turnover*, 42 J. Acc’t. Res. 269, 283 (2004) (CEO turnover rates over period 1996-2002, 14% for US firms and 16% for UK firms).

⁵² Under a staggered board provision, only a proportion of the board may be removed at any given annual meeting, so that it will typically take two to three years to wrest control of the board following a takeover: see Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885 (2002). The default rule for appointments in UK companies is in fact a 3-year staggered board (see,

UK company law also give shareholders the right to nominate and appoint directors.⁵³ Whilst this is not protected by a mandatory rule, any attempt to entrench a board by removing these rights would be ineffective given the shareholders' overriding power to remove directors: shareholders could credibly threaten to remove immediately any director with whom they are not content. Moreover, the shareholders have the power to modify the company's constitution, including the provisions on election of directors.⁵⁴

Not only can UK shareholders to fire managers at a shareholders' meeting, but they can also requisition a meeting for the purpose. Shareholders together holding more than 10% of a company's voting rights may require the holding of a general meeting, and require proposed resolutions to be circulated to shareholders at the company's expense.⁵⁵ A recent study of UK and US shareholder proposals and meeting requisitions found that whereas US shareholder proposals cover a diverse range of issues, UK proposals and meeting requisitions focus very closely on applications to remove or elect specific directors, and in a significant number of cases, the entire board.⁵⁶

Insofar as voting at meetings is concerned, it is a mandatory rule of UK company law that resolutions are passed by a majority of the votes cast in the meeting.⁵⁷ Whilst the same basic rule applies under Delaware law, it does not extend to the appointment of directors.⁵⁸ In contrast, for the appointment of directors the standard Delaware rule is so-called 'plurality' voting, under which the directors are elected who receive the largest number of votes in favor. This means that

e.g., Companies Act 1985, Table A, SI 1985/805 ('1985 Table A'), Art. 74), but this is subject to the exercise of the mandatory removal power.

⁵³ See 1985 Table A, Arts. 76-78. These provisions are found in the model articles of association (equivalent to a corporate charter or bylaws in the US), which apply to the extent that they are not expressly excluded: Companies Act 2006, § 20(1).

⁵⁴ Companies Act 2006 § 21.

⁵⁵ Companies Act 2006 §§ 303-305. Moreover, shareholders in holding more than 5% of the voting rights in public companies may require resolutions to be put onto the agenda for the AGM, and circulated to shareholders in advance, also at the company's expense (Companies Act 2006 §§ 338-339).

⁵⁶ Bonnie Buchanan and Tina Yang, A Comparative Analysis of Shareholder Activism in the US and UK: Evidence from Shareholder Proposals, paper prepared for Oxford/Yale conference on UK-US corporate governance (2007), 44-45 (82% of UK shareholder proposals/meeting requisitions are concerned with removing or electing specific directors; only 30% of US shareholder proposals relate to board issues, and of these only 6% seek appointment of a particular director).

⁵⁷ Companies Act 2006 §§ 282-283.

⁵⁸ DGCL § 216.

it is not possible to vote ‘against’ a particular director, and that directors may be appointed even if they do not receive a majority of the votes.

In addition to the foregoing, the UK’s regulatory environment also restricts managers’ ability to entrench themselves with generous termination payments.⁵⁹ The Combined Code on Corporate Governance provides that directors’ notice periods should not ordinarily be longer than one year,⁶⁰ and under the companies legislation, any notice period greater than two years must be pre-approved by the shareholders.⁶¹ Moreover, publicly-traded UK companies have since 2002 been required to send shareholders each year a directors’ remuneration report—including details of notice periods and termination payments—on which a precatory shareholder vote must be taken at the AGM.⁶² Empirical studies suggest that the introduction of these precatory resolutions in the UK have had a restraining impact on executive pay.⁶³

Non-voting and dual-class stock, another well-known entrenchment device, whilst not prohibited by the UK Listing Rules, are strongly discouraged by the London Stock Exchange and the investment community.⁶⁴ As a result, they are relatively rare.⁶⁵ A recent study commissioned

⁵⁹ Exercise of the summary removal power by the shareholders will constitute a repudiation of an executive director’s service contract: see Companies Act 2006 § 168(5)(a). See also *Southern Foundries v Shirlaw* [1940] AC 701.

⁶⁰ Financial Reporting Council, The Combined Code on Corporate Governance June 2006 (‘Combined Code 2006’) (2006), ¶ B.1.6. In both jurisdictions, executive compensation is usually determined in the first instance by a remuneration committee comprised of outside (‘non-executive’ in the UK parlance) directors. On the UK position, see Combined Code 2006, ¶¶ B.2.1-2.3. On the US position, see [...]

⁶¹ Companies Act 2006 § 188.

⁶² Companies Act 2006 §§ 420-421, 439; Companies Act 1985 Sch 7A, ¶¶ 3(4), 5(1). These provisions were introduced from 1 August 2002 by the Directors’ Remuneration Report Regulations 2002, SI 2002/1986. See generally, Freshfields Bruckhaus Deringer, Directors’ Remuneration Report Regulations: Checklist, Commentary and Related Best Practice (2007).

⁶³ See Fabrizio Ferri and David Maber, Say on Pay Vote and CEO Compensation: Evidence from the UK, working paper (2008) (compared to control group in US, UK executives’ pay packages since 2002 exhibit greater downwards sensitivity—that is, poor performance is associated with less pay); Mary Ellen Carter and Valentina Zamora, Shareholder Remuneration Votes and CEO Compensation Design, working paper (2008) (shareholders more likely to express dissatisfaction with higher CEO salaries and weaker pay-performance sensitivity); Walid M. Alissa, Boards’ Response to Shareholders’ Dissatisfaction: The Case of Shareholders’ Say on Pay in the UK, working paper (2009) (shareholder dissatisfaction associated with subsequent reduction in excess CEO compensation and increased likelihood of CEO turnover).

⁶⁴ See Julian Franks, Colin Mayer, and Stefano Rossi, Spending Less Time with the Family: The Decline of Family Ownership in the UK, NBER Working Paper No 10628 (2004), 1-2.

from Deminor, a proxy voting consultancy, by the Association of British Insurers, reported that as of 2004, 88% of large listed UK companies conformed strictly to the ‘one share, one vote’ principle.⁶⁶

2. Shareholder Choice in Takeovers

The board’s vulnerability to removal by shareholders is coupled with firm restrictions on their range of responses to takeover challenges. The UK’s Takeover Code imposes a ‘no frustrating action’ principle upon the managers of a target company, that prohibits them from taking, once a bid is launched or anticipated, any actions that might have the consequence of frustrating its success, without first obtaining the consent of their shareholders.⁶⁷ It is widely believed that the threat of hostile takeovers can act as a check on managerial agency costs. In line with this, the likelihood of a publicly-traded UK firm being a takeover target, particularly of a hostile bid, appears to increase if its performance worsens.⁶⁸ Moreover, hostile bids appear to be more likely to occur, and if made, more likely to succeed, in the UK than in the US.⁶⁹

Defenders of the US ‘board choice’ model sometimes argue that it is a way of delegating to managers a set of decisions shareholders may not be well-placed to make.⁷⁰ It permits incumbent directors either to reject unwanted offers, or to negotiate a higher price for their firm, thus benefiting target shareholders. The extent to which this is useful likely depends on the types

⁶⁵ See, e.g., ‘Error Deprives Schroders of FTSE 100 Place’, *Financial Times*, March 15, 2007 (‘Unusually for a UK company, Schroders has voting and non-voting shares.’)

⁶⁶ Deminor, *Application of the One Share – One Vote Principle in Europe* (2005), 17. Whilst in the region of 5% of UK companies still have some non-voting stock in issue (*ibid.*), the proportion has been declining over time, and those that remain are legacy issues, as opposed to new issues (Franks *et al.*, *supra* note 64, 21-22).

⁶⁷ City Code, GP 7 and Rule 21. See also John Armour and David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, 95 *Geo. L.J.* 1727, 1734-1738 (2007).

⁶⁸ Julian Franks, Colin Mayer, and Luc Renneboog, *Who Disciplines Management in Poorly Performing Companies?*, 10 *J. Fin. Intermed.* 209, ___ - ___. However, target management are very likely to be replaced following a successful takeover, regardless of whether or not it is friendly, and of the firm’s performance, suggesting that, as a disciplinary mechanism, the takeover bid is very unfocused: Julian Franks and Colin Mayer, ‘Hostile Takeovers in the UK and the Correction of Managerial Failure’ 40 *Journal of Financial Economics* 163 (1996); see also Franks *et al.*, *supra* note xx, 233-234.

⁶⁹ Armour and Skeel, *supra* note 67, 1738.

⁷⁰ See, e.g., Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 *U. PA. L. REV.* 473 (2003).

of shareholder involved. Retail investors may benefit from delegating these questions to management; institutional investors are quite capable of rejecting a bid if they feel it is not going to create sufficient value, as notoriously occurred in NASDAQ's bid for London Stock Exchange plc.⁷¹ Interestingly, the empirical literature shows no appreciable difference in bid premia for target shareholders in US and UK firms.⁷²

3. Control over Significant Corporate Transactions

Another aspect of the governance mechanisms employed in the UK to control managerial agency costs is the role played by shareholder approval in relation to certain categories of corporate transaction—namely, those involving either a risk of conflict of interest, or those which are of significant magnitude in relation to the size of the company.⁷³ The most wide-ranging of the relevant provisions are located in the UK Listing Rules, and are regarded by UK institutional shareholders as an important mechanism of control over corporate boards.⁷⁴ These require, in relation to significant transactions, that details of all transactions of a value between 5-25% of the company's business ('Class 2 transactions') must be disclosed to shareholders.⁷⁵ For transactions in excess of a 25% threshold ('Class 1 transactions'), the disclosure must be supplemented by a stockholder vote on the transaction.⁷⁶ And for transactions with any 'related party' (extensively defined),⁷⁷ disclosure must be supplemented by a stockholder vote, excluding the votes of the related party and their associates.⁷⁸

⁷¹ Newspaper reports

⁷² See Armour and Skeel, *supra* note 67, 1740n. (reviewing literature).

⁷³ UK Listing Rules, LR 10, 11. In addition, the UK's general companies legislation requires that for certain transactions to which the counterparty is either a director or their associate (including companies in which they hold controlling shareholdings), shareholder approval must be sought. Most significantly, this encompasses substantial property transactions (Companies Act 2006 §§ 190-196) and corporate loans or similar transactions with directors (*ibid.*, §§ 197-214).

⁷⁴ See GEOFF P. STAPLEDON, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE, 130-131 (1996).

⁷⁵ LR 10.4.1. A series of different ratio tests, relating to assets, consideration, and profits, are applied cumulatively: LR 10.2.

⁷⁶ LR 10.5.1.

⁷⁷ LR 11.1.4. The definition includes not only directors and significant shareholders (>10% voting rights), but any 'person exercising significant influence' or any 'associate' (extensively defined) of the foregoing categories.

⁷⁸ LR 11.1.7.

4. Control over Seasoned Equity Issues

Another distinguishing feature of the UK corporate governance environment is the strong focus on shareholder's pre-emption rights regarding seasoned equity issues. Such rights are applied as default rules to all companies under company law,⁷⁹ and supplemented by provisions in the Listing Rules for firms listed on the UK Official List,⁸⁰ although their application may be waived *ex post* by shareholder authorization.⁸¹

Most obviously, pre-emption rights are seen as protection for shareholders from the risk of dilution associated with an open offer. However, they also appear to play a more significant governance role in the UK, by providing a focal point around which shareholders can centre monitoring and engagement with the company. A discounted rights issue creates a threat of dilution for investors who do not subscribe. On the other hand, investors who do subscribe have an initial monopoly over the new investment. The amount at stake will depend on the terms of the issue and the reasons the company is seeking further finance. Thus there will typically be dialogue between a company and its major institutional investors the period prior to a rights issue.⁸² For this reason, rights issues are strongly correlated with managerial turnover. Two studies have documented a strong positive relation between rights issues by UK listed firms and managerial change.⁸³ Indeed, in a comparison with a number of other 'disciplinary mechanisms'

⁷⁹ Companies Act 2006 §§ 560-577.

⁸⁰ LR 9.3.11-12. Moreover, shares may not be issued at a discount of more than 10% to their current market price unless as a rights issue or specifically approved by shareholders: LR 9.5.10. The protection for investors found in the Listing Rules is stronger than under the Companies Act: see Eilís Ferran, *Legal Capital Rules and Modern Securities Markets—the Case for Reform, as Illustrated by the UK Equity Markets*, in KLAUS HOPT AND EDDY WYMEERSCH (eds.), *CAPITAL MARKETS AND COMPANY LAW*, 115, 131-33 (2003).

⁸¹ Companies Act 2006 §§ 570-571; LR 9.3.12(1). The grant of such a waiver is, however, subject to a well-established set of voting guidelines adhered to by institutional investors in the UK. For the latest version, see PRE-EMPTION GROUP, *DISAPPLYING PRE-EMPTION RIGHTS: A STATEMENT OF PRINCIPLES* (2006), available at <http://www.pre-emptiongroup.org.uk/documents/pdf/DisapplyingPre-EmptionRightsStatementofPrinciples.pdf> (consent will be granted uncontroversially for issues amounting to less than 5% of ordinary share capital in any given year; where issue amounts to more than 7.5% of the ordinary capital, a business case for waiver must be made: *ibid.*, principles 8-9, 14-15).

⁸² STAPLEDON, *supra* note xx, 129-130; Paul Myners, *Pre-Emption Rights: A Final Report*, URN 05/679 (2005).

⁸³ Franks *et al.*, *supra* note 68, 234-235; David Hillier, Scott C. Linn and Patrick McColgan, *Equity Issuance, CEO Turnover and Corporate Governance*, 11 *Eur. Fin. Manag't.* 515 (2005).

in the UK—including hostile takeovers—rights issues are most strongly associated with managerial turnover in underperforming firms.⁸⁴

It might be thought that shareholder control over seasoned equity issues might lead managers to be conservative with dividend payments, in order to bolster their financial position against the need to raise finance by seasoned equity. As in the US, dividend payments in the UK are ordinarily determined in the first instance by a board recommendation, followed by a shareholder vote.⁸⁵ However, given UK boards' vulnerability to removal by shareholders, and their inability to take defensive action against a takeover, such a strategy would be short-sighted.⁸⁶ Historically, low dividend yields were the classic precursor to a hostile takeover;⁸⁷ correspondingly, dividend growth in UK stocks has generally been higher than in their US counterparts.⁸⁸

4. Restraints on *Intra*-Shareholder Agency Costs

As we have seen, UK shareholders have greater powers than their US counterparts to control managers using governance mechanisms. With this, however, comes a risk that shareholders may use this power opportunistically. In particular, there is a concern that shareholders having a block of shares with sufficient voting power to influence outcomes might act in a way that benefits themselves, at the expense of other shareholders. This concern becomes greater if the blockholder's voting power is, by whatever means, greater than their economic stake in the firm.⁸⁹ Recently, the advent of derivatives have worsened the potential for this sort of problem, as blockholders may now be able to hedge their position completely, so as to have voting rights but no economic interest in the firm.⁹⁰ Similarly, stock lending facilitates the assembly of a voting

⁸⁴ Franks *et al*, *supra* note 68, 226, 244-46.

⁸⁵ See, e.g., Table A 1985, Art. 102.

⁸⁶ See Brian R. Cheffins, *Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom*, 63 Wash. & Lee L. Rev. 1273 (2006).

⁸⁷ See Armour and Skeel, *supra* note 67, 1756-1758.

⁸⁸ See Elroy Dimson and Paul Marsh, *UK Financial Market Returns, 1955-2000*, 74 J. Bus. 1, 22-26 (2001) (Real dividend growth for UK stocks higher than in US over this period).

⁸⁹ See Lucian Ayre Bebchuk, Reinier Kraakman, and George Triantis, *Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in RANDALL C. MORCK (ed.), *CONCENTRATED CORPORATE OWNERSHIP*, 445 (2000).

⁹⁰ Henry C. Hu and Bernard S. Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 So. Cal. LR 811 (2006).

position at the time of a general meeting which, because the price of the ‘lending’ agreement is fixed prior to the meeting, means that the ‘borrower’ does not bear any economic consequences associated with the exercise of their voting rights.⁹¹

As in the US, the basic starting point in UK corporate law regarding shareholder voting is that a shareholder may vote as he or she pleases.⁹² However, there are a number of dimensions over which the UK corporate governance environment acts to control such opportunism, which are, as predicted, stronger than the corresponding controls in the US. We now review these briefly.

1. Restraints on Blockholding and Non-voting Shares

The first set of restrictions act to constrain the ability of UK blockholders to aggregate voting power—whether directly, through a large block of shares, or indirectly, through pyramid structures. The most significant restriction is perhaps the Takeover Code’s ‘mandatory bid’ rule. This requires that any person, or group of persons acting together in concert,⁹³ who acquires an interest in a company’s shares carrying more than 30% of the voting rights must make a bid to acquire control of the rest of the shares (voting and non-voting).⁹⁴ The purpose of the mandatory bid rule is to promote equality of treatment amongst shareholders—that is, to ensure that who wish to sell to a bidder are able to do so at the best price offered.⁹⁵ However, it has the effect, which does not appear to have been intended at the time of its introduction,⁹⁶ of limiting the extent of control block formation in British companies. Consequently, the distribution of the

⁹¹ *Ibid.*; Marcel Kahan and Edward B. Rock, ‘The Hanging Chads of Corporate Voting’, U Penn Inst for Law & Econ Research Paper No 07-18, NYU Law and Economics Research Paper No 07-29.

⁹² See, e.g., *N.W. Transportation Co v Beatty* (1887) 12 App Cas 589; *Burland v Earle* [1902] AC 83.

⁹³ A group of shareholders will be ‘acting in concert’ where they co-operate, pursuant to an agreement or understanding (which may be formal or informal) to obtain or consolidate control of a company (Takeover Code, C1). ‘Control’ is taken to mean simply the holding of shares carrying more than 30% of the voting rights (*ibid.*, C6).

⁹⁴ Takeover Code, Rule 9.1.

⁹⁵ A mandatory bid must offer each shareholder the best cash price that the bidder has paid for shares in the target company acquired on the open market during the 12 months prior to the bid (*ibid.*, Rule 9.5(a)).

⁹⁶ The origins of the mandatory bid rule are described in Armour and Skeel, *supra* note 67, 1763-64.

largest blockholdings in British companies is curtailed at just under 30%.⁹⁷ To be sure, a voting block of less than 30% is often sufficient to ensure practical control in many publicly-traded firms,⁹⁸ but the mandatory bid rule nevertheless imposes an upper bound on majority shareholder power in a given firm. In addition, the hostility of UK investors to non-voting shares means that blockholders are greatly restricted in their ability to use these to enhance their control.⁹⁹

In addition to these outright restrictions, there were for over 25 years restrictions on the *speed* with which a purchaser could build up a stake in a company. The Substantial Acquisitions Rules ('SARs'), which were imposed by the Takeover Panel from 1980 until 2006, prohibited a buyer (or a group of buyers acting in concert) from acquiring more than 10% of a company's voting rights if his aggregate holding would thereby amount to between 15% and 30%.¹⁰⁰ The SARs were originally introduced following concerns that 'dawn raids' (what in the US would be termed a 'street sweep') on the market,¹⁰¹ whereby just under the 30% threshold would be bought in a very short space of time, would deny some shareholders the opportunity to sell their shares at a potentially favorable price.¹⁰² They were abolished in 2006, following the Takeover Panel's conclusion that investors are now less likely to sell into a market raid, given that if they wait, stock value is likely to appreciate following the acquisition of a toehold.¹⁰³

⁹⁷ See, e.g., Marco Becht and Colin Mayer, *Introduction*, in FABRIZIO BARCA AND MARCO BECHT (EDS.), *THE CONTROL OF CORPORATE EUROPE*, 1, 26 (2001); Marc Goergen and Luc Renneboog, *Strong Managers and Passive Institutional Investors in the UK*, in BARCA AND BECHT (eds.), 259, 268 (2001).

⁹⁸ US poison pill triggers are often set at 15%, or even 10% [cite?].

⁹⁹ See *supra*, text to notes 64-66.

¹⁰⁰ SAR 1. There were exceptions if the purchaser (i) acquired a block from an existing blockholder; (ii) had announced a firm intention to make a bid; or (iii) made the acquisition pursuant to a tender offer (SAR 2). Once the 30% threshold was reached, the purchaser would trigger the obligation to make a mandatory bid under Rule 9 of the Takeover Code.

¹⁰¹ See, 'Secret Buyer's £100m Gold Shares Deal', *The Times*, 7 February 1980, 1; 'Inquiry on Buying of Gold Shares Sought', *The Times*, 12 February 1980, 1; "'Dawn Raid" on Revertex Shares', *The Times*, 26 April 1980, 19; "'Dawn Raid" Nets Pergamon 29.5pc in BPC', *The Times*, 19 July 1980, 17.

¹⁰² See 'City Puts Ban on "Dawn Raids" Pending new Code of Conduct', *The Times*, 8 August, 1980, 13 (ban on acquisition of more than 15%); 'Sun Sets on the Dawn Raiders', *The Times*, 10 December 1980, 23; 'Watchdog Curbs Quick-Fire Raiders', *The Times*, 25 September 1981, 17.

¹⁰³ See Panel on Takeovers and Mergers, *Proposed Abolition of the Rules Governing Substantial Acquisitions of Shares*, PCP2005/4, 8-9 (2005).

2. Disclosure of Blockholdings

Accurate and timely disclosure of share ownership positions—in particular, of economic and voting positions—allows investors to be aware *ex ante* of the potential risks they face regarding the actions of other shareholders, and also *ex post* of the likely motivation behind shareholder votes. As such, it would allow the market to price the expected impact of a particular blockholder's conduct into securities more rapidly. It also allows other shareholders to take countervailing positions where they wish to prevent a particular investor from expropriating assets.

In both the UK and US, shareholders with significant holdings of voting shares are required to disclose their interest to the company, and to have this entered into a publicly-available register. These provisions were first introduced in the late 1960s, and contain many similarities.¹⁰⁴ In both jurisdictions, the scope of the provisions has been expanded to include two or more purchasers acting in concert, and subsequent changes in a block that has crossed the disclosure threshold must also be notified.¹⁰⁵ Moreover, both have less restrictive provisions for investment managers. However, the UK provision has, since 1989, been more restrictive than a 13D filing in the US, because it is triggered at a threshold of 3%, rather than 5%, and must be made within 2 days, as opposed to the 10 days permitted in the US.¹⁰⁶ This difference pales into insignificance, however, when attention is paid to the disclosure requirements imposed by the UK's Takeover Code during an offer period.¹⁰⁷ Under these, declared bidders, and any other person owning or controlling more than 1% of any class of relevant securities in the target must disclose all dealings in the target within 1 day.¹⁰⁸

Moreover, in addition to these automatic, or reactive, disclosure requirements, UK companies have a power to request information proactively concerning beneficial interests in their shares from any persons they reasonably believe may have, or have had, such an interest.¹⁰⁹

¹⁰⁴ See Companies Act 1967, § 33; Williams Act 1968 [...]

¹⁰⁵ FSA, DTR 5; SEC Rule 13d-1, 13d-2.

¹⁰⁶ Companies Act 1989, § 134. See now FSA, DTR 5.

¹⁰⁷ ;An offer period begins when there has been an announcement as to an actual or potential takeover.

¹⁰⁸ Takeover Code, rule 4. Moreover, bidders may not sell any stock in the target without the permission of the Takeover Panel, and with 24 hours public notice that a sale may occur.

¹⁰⁹ Companies Act 2006 § 793. Information received following such a request must be disclosed by the company (*ibid.*, §§ 808-811). Moreover, an exercise of this power can be requisitioned by a 10% shareholder: *ibid.*, § 803.

There are powerful sanctions for non-compliance with such a request. Not only does this constitute a criminal offence, but the company may also impose restrictions on voting, entitlement to receive dividends, or ability to transfer the shares.¹¹⁰ Such proactive requests are commonly used by UK companies to maintain an understanding of their shareholder body.

In recent years, the dramatic growth of derivative contracts referenced to equity securities has increased the possibilities for the creation of synthetic equivalents to pyramid ownership structures. One possibility, termed ‘empty voting’ by Hu and Black, involves hedging out the economic interest in shares, leaving the shareholder with bare control rights, and perverse incentives as regards voting. Whilst US regulators have struggled to respond to this phenomenon, the UK’s Takeover Panel has, since May 2006 required disclosure of dealings in long equity swaps in the same fashion as regards the underlying securities.¹¹¹ Even more expansively, the UK’s Financial Services Authority is currently consulting over whether such derivative disclosure requirements should be extended to equalize with the general block disclosure rules outside takeover situations.¹¹²

3. Regulation of Non-public Information

[To follow: Insider dealing/market abuse regime in UK covers coordination between investors expecting to use governance rights in a way that will affect stock price. Not so covered in US]

4. Control of Voting

Intra-shareholder agency problems may manifest themselves through voting in a variety of ways. The most obvious is where a blockholder uses their votes to procure or ratify a transaction that benefits itself at the expense of the company. Mechanisms responding to this problem have been present in UK company law since its inception in the nineteenth century. On the one hand, directors of a UK company owe duties solely to the company, and if they act partially in favor of

¹¹⁰ *Ibid.*, §§ 794-798.

¹¹¹ See TAKEOVER PANEL, DEALINGS IN DERIVATIVES AND OPTIONS: OUTLINE PROPOSALS, PCP 2005/1 (2005); TAKEOVER PANEL, CONSOLIDATED AMENDMENTS TO THE TAKEOVER CODE EFFECTIVE ON 20 MAY 2006 (2006).

¹¹² See FSA, DISCLOSURE OF CONTRACTS FOR DIFFERENCE: CONSULTATION AND DRAFT HANDBOOK TEXT, CP07/20 (2007).

an appointing shareholder, they will breach these duties.¹¹³ Moreover, they owe a duty to act fairly as between different classes of shareholder.¹¹⁴

On the other hand, whilst shareholders owe no *duties* by virtue of their position as shareholders,¹¹⁵ they may be subjected to *disabilities* that restrain their ability to vote in a way that harms the interests of other shareholders. The most fundamental of these is that resolutions passed in general meeting must be passed in good faith in the interests of the company as a whole.¹¹⁶ That is, the members of the majority voting in favor of the resolution must subjectively believe that the measure in question is for the furtherance of the interests of the company as a whole, as opposed to their sectional interests. This standard is ordinarily not very difficult to satisfy, requiring simply the existence of some plausible business purpose,¹¹⁷ but majority shareholders will not be permitted to use their votes to pass a transaction benefiting themselves sectionally at the expense of the company.¹¹⁸

Challenging such a transaction under the foregoing rules requires *ex post* litigation; far more effective in protecting UK shareholders from blockholder expropriation is the *ex ante* restriction on related party transactions imposed by the Listing Rules. Any transactions, in excess of a *de minimis* threshold, between a company or any of its subsidiaries and a ‘related party’ (extensively defined),¹¹⁹ must be preceded by disclosure and conditional on a stockholder vote, from which the votes of the related party and their associates are excluded.¹²⁰

¹¹³ *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 AC 187, 220-222.

¹¹⁴ *Mutual Life Insurance Co of New York v Rank Organisation Ltd* [1985] BCLC 11, 21-22; *Re BSB Holdings (No 2)* [1996] 1 BCLC 155, 246-249. This principle is now codified as Companies Act 2006 s 172(1)(f).

¹¹⁵ *Kuwait Asia Bank*, *supra* n 113, 217-220.

¹¹⁶ *Allen v Gold Reefs of West Africa* [1900] 1 Ch 656, 671; *British America Nickel Corporation Ltd v MJ O’Brien Ltd* [1927] AC 369, 371-373; *Peters’ American Delicacy Co Ltd v Heath* (1939) 61 CLR 457, 511-513; *Re Holders Investment Trust Ltd* [1971] 2 All ER 289, 291; *Re BSB Holdings (No 2)*, *supra* n 114, 234; *Redwood Master Fund Ltd v TD Bank Europe Ltd* [2006] 1 BCLC 149 at [105]-[106]. There is considerable debate over the scope of the types of resolution to which this rule applies. At its narrowest, it applies only to resolutions concerned with alterations of the company’s constitution; at its broadest, it applies to all types of shareholder resolution: see *Re BSB Holdings (No 2)*, *supra* n 114, 234.

¹¹⁷ See *Greenhalgh v Arderne Cinemas* [1951] Ch 286.

¹¹⁸ Discuss fraud on minority caselaw.

¹¹⁹ LR 11.1.4. The definition includes not only directors and significant shareholders (>10% voting rights), but any ‘person exercising significant influence’ or any ‘associate’ (extensively defined) of the foregoing categories.

¹²⁰ LR 11.1.7.

A second way in which intra-shareholder agency problems may occur in relation to voting occurs through strategic manipulation of the voting process. In this regard, long periods between the record dates at which entitlements to vote are determined and the actual meetings lend themselves to abuse. A shareholder at the record date may vote even if they are no longer actually a shareholder at the date of the meeting.¹²¹ Whilst the foregoing mechanisms—in particular, the related party transactions rules—would ameliorate the perverse incentives which might result, the structure of the UK system acts to make this type of voting arbitrage much more difficult in any event.

In both jurisdictions, only registered shareholders are entitled to vote at meetings.¹²² Under Delaware law, the board may set a ‘record date’ up to 60 days before the meeting, at which point entitlements to vote will be determined from the register.¹²³ In the UK, on the other hand, record dates are no longer than 48 hours before the meeting.¹²⁴ The effect of the very short record date in the UK is to make it much more difficult to ‘capture’ votes through transactions immediately around the record date.

The UK’s regulatory environment has also started to respond to the particular issues raised by stock lending in this context.¹²⁵ A stock ‘lending’ transaction is technically a sale and resale. The resale price may be fixed under the terms of the lending agreement,¹²⁶ so the borrower need not bear the economic consequences associated with voting in a way adverse to the issuer’s interests. The Bank of England has since 1990 chaired a committee of trade associations, known as the Securities Lending and Repo Committee, which has since April 1994 produced a code of

¹²¹ See Hu and Black, *supra* note 90, 832-835; Kahan and Rock, *supra* note 91, 27-31.

¹²² UK Companies Act 2006, § 327; DGCL § 219(c).

¹²³ DGCL § 213(a) (record date may not be more than 60 days or less than 10 days before a stockholder meeting).

¹²⁴ This is a mandatory rule for uncertificated securities: see Uncertificated Securities Regulations 2001, SI 2001/3755, Reg. 41, first introduced in 1995. For ordinary securities, this is a matter for the company’s constitution, but publicly-traded companies typically align the position with that which will apply for their uncertificated securities: see, e.g., BP plc, Memorandum and Articles of Association, Art. 60(D) (48 hours prior to meeting). This reflects long-standing commercial practice preceding the introduction of the mandatory rule in 1995.

¹²⁵ As appears to have occurred in the case of Laxey Partners’ activism in relation to British Land plc in 2002: see Hu and Black, *supra* note 90, at 816-817.

¹²⁶ See, e.g., MARK C. FAULKNER, AN INTRODUCTION TO SECURITIES LENDING, 9 (2004).

guidance to market participants as regards stock lending.¹²⁷ This makes clear that ‘securities should not be borrowed solely for the purpose of exercising the voting rights’ at a shareholders’ meeting.¹²⁸

Thus we see that in the UK, there are greater constraints on intra-shareholder agency costs in publicly-traded firms than exist in the US. Blockholdings are subject to restrictions on absolute size, and were for many years subject to restrictions on the speed at which they could be accumulated. Blockholders are also required to disclose their interests in both jurisdictions, but in the UK the basic disclosure threshold is set at a lower level, disclosure is required much more rapidly, and extraordinary transparency obligations are imposed during a takeover situation. Finally, both jurisdictions have difficulty to implement *ex post* review standards for egregiously manipulative self-interested voting, but the UK supplements this with an *ex ante* approval requirement, excluding the self-interested votes, for any related party transaction. Moreover, the UK’s short record dates and code of conduct on stock lending go some way to ameliorating concerns that have recently emerged concerning vote arbitrage through ‘record date capture’.

5. Disclosure Obligations

The third dimension across which we have predicted differences in dispersed ownership systems according to predominant shareholder type is disclosure. Here we are referring to requirements imposed on firms regarding prospectus and continuing disclosure. The UK’s disclosure regime has historically been much less onerous as regards continuing disclosure than that which has been operant in the US since 1934. However, in recent years, continuing disclosure obligations for UK publicly-traded firms have been significantly increased, in line with the EU’s Financial Services Action Plan.¹²⁹

Both jurisdictions have prospectus liability regimes. In the UK, this has existed since 1890; in the US, since 1933. For the control of managers of publicly-traded firms, however, it is continuous disclosure obligations that are the most salient. These encourage the transmission of information about the firm’s business performance to the market. In the US, firms registered

¹²⁷ See Bank of England, Securities Lending and Repo Committee, <http://www.bankofengland.co.uk/markets/gilts/slr.htm>.

¹²⁸ SECURITIES LENDING AND REPO COMMITTEE, SECURITIES BORROWING AND LENDING CODE OF GUIDANCE (2004), 17.

¹²⁹ See generally, EILÍS FERRAN, BUILDING AN EU SECURITIES MARKET, 135-138, 197-200 (2004); HM Treasury/FSA/Bank of England, The EU Financial Services Action Plan: Delivering the FSAP in the UK, 2-16 (2004).

under the Securities Exchange Act of 1934 must file annual and quarterly reports as prescribed by the SEC (Forms 10-K and 10-Q respectively),¹³⁰ and *ad hoc* statements following material events. In addition, stock exchange regulations require prompt public disclosure of any price-sensitive information. The real force of US continuing disclosure requirements date from the 1970s, when the SEC pursued a policy of integrating prospectus and continuing disclosure, upgrading the content of the latter to the standard of the former. Since the early 1970s, both the scope of the required disclosures, and the amount of information disclosed, (as measured by the length of the 10-K forms) have grown exponentially.¹³¹ In particular, in their annual 10-K disclosures, US firms have since 1974 been required to supplement historic accounting data with narrative information on the accounts and a forward-looking review of the business, the so-called ‘Management’s Discussion and Analysis’ (MD&A) of the financial condition and results of operations. This was coupled, from 1979, with the creation of a ‘safe harbour’ for forward-looking statements, thereby encouraging dissemination of this type of information.¹³² Empirical studies report that subsequent to the introduction of the MD&A requirement, stock prices of US publicly-traded firms appear to have become more responsive to firm-specific, rather than market-wide, factors.¹³³

In the UK, firms have been required to prepare and disseminate to investors annual accounts since 1948,¹³⁴ along with an accompanying directors’ narrative report on the state of the company’s business and any material changes over the course of the year.¹³⁵ However, the annual accounts were not particularly informative to investors: as Professor Gower—the leading authority on UK company law at the time—put it in 1957, “to the average investor ... they are cryptograms which he is incapable of solving.”¹³⁶ Little further assistance was derived from the

¹³⁰ Securities Exchange Act 1934 § 13(a); SEC Rules 13a-1, 13a-13.

¹³¹ Jeffrey N. Gordon, Independent Directors and Stock Market Prices: The New Corporate Governance Paradigm, ECGI Law Working Paper No 74/2006, 76-84 (2006).

¹³² SEC, Securities Act Release No. 6084 (June 25, 1979) (adopting rule 175, 17 CFR S 230.175).

¹³³ See Merritt Fox, Randall Morck, Bernard Yeung & Artyom Durnev, *Law, Share Price Accuracy, and Economic Performance: The New Evidence*, 102 Mich L. Rev. 331 at 370-378 (2003). [see also ...]

¹³⁴ The circulation of balance sheets to shareholders was mandatory from 1908, and from 1929 this was supplemented with profit and loss accounts. From 1948, these annual financial statements were required to be made available to the general public.

¹³⁵ Companies Act 1948 §157.

¹³⁶ L.C.B. GOWER, *PRINCIPLES OF MODERN COMPANY LAW*, 416 (2nd ed., 1957).

generic directors' report, which Gower described as typically being "formal, colourless, and of little value".¹³⁷ The contents of the required information in the directors' report increased gradually over time.¹³⁸ From the early 1980s, half-yearly accounts and management reports, and quarterly management statements were also required.¹³⁹ Finally, from early 2006, UK publicly-traded companies have been required to include a forward-looking narrative statement in their annual directors' report outlining "the main trends and factors likely to affect the future development and performance of the company's business."¹⁴⁰

Publicly-traded firms have also long been required to supplement their periodic disclosures with continuing disclosure obligations imposed by the London Stock Exchange and latterly the FSA. Since at least the early postwar period, publicly traded firms were required under their listing contract to disclose all "information necessary to enable the shareholders to appraise the position of the company and to avoid the establishment of a false market."¹⁴¹ During the 1970s, this was enhanced to include specific *ad hoc* disclosures relating to significant corporate transactions and related party transactions,¹⁴² and from the implementation of the EC's Admissions Directive in 1979, "major developments" which might lead to "substantial

¹³⁷ L.C.B. GOWER, *PRINCIPLES OF MODERN COMPANY LAW*, 516 (4th ed., 1979).

¹³⁸ The Companies Act 1967 required that directors' self-interested transactions and share dealings be disclosed; [add further details].

¹³⁹ LSE Rules [check]; The requirement for half-yearly interim accounts implemented the Regular Reporting Directive (Council Directive 82/121/EEC of 15 February 1982 on information to be published on a regular basis by companies the shares of which have been admitted to official stock exchange listing [1982] OJ L48/29). See generally, VANESSA EDWARDS, *EC COMPANY LAW*, 261-265 (1999). [Note prospective financial information due diligence requirements in Listing Rules—see FSA *Listing Rules Review* at 61]

¹⁴⁰ Companies Act 2006 § 417(5)(a). The UK government had originally legislated, following the recommendation of the independent Company Law Review, for the introduction of a much more extensive mandatory forward-looking disclosure in the form of an audited Operating and Financial Review ('OFR'), which was scheduled for introduction in 2006. However, following extensive lobbying from business groups concerned about the likely expense of implementing the OFR, the government performed a sudden U-turn in early 2006, repealing the legislation before it came into force and replacing it with the current Business Review requirement: see HM Treasury, *Directors' Reporting—Removing the Statutory Requirement to Produce an Operating and Financial Review*, Note to Chancellor 23 November 2005, available at http://www.hm-treasury.gov.uk/media/4/0/eascadvice23nov_020306.pdf.

¹⁴¹ L.C.B. GOWER, *PRINCIPLES OF MODERN COMPANY LAW*, 414 (2nd ed., 1957).

¹⁴² See L.C.B. GOWER, *PRINCIPLES OF MODERN COMPANY LAW*, 332-333 (5th ed., 1992).

movements” of its stock price.¹⁴³ This has applied more strictly since the UK’s implementation in 2005 of the Market Abuse Directive,¹⁴⁴ whereby UK publicly-traded firms are now required to disclose any price-sensitive information to the market as soon as possible.¹⁴⁵

The role that UK courts have traditionally understood continuing disclosure as playing is revealing. This was articulated very clearly in the case of *Caparo Industries plc v Dickman*.¹⁴⁶ There the House of Lords made clear that the central purpose of periodic disclosure was not to protect or inform potential investors, but rather to permit the shareholders to decide whether to exercise their governance rights.¹⁴⁷ As Lord Jauncey explained,¹⁴⁸

“[T]he purpose of annual accounts, so far as [shareholders] are concerned, is to enable them to question the past management of the company, to exercise their voting rights, if so advised, and to influence future policy and management. Advice to individual shareholders in relation to present or future investment in the company is no part of the statutory purpose of the preparation and distribution of the accounts.”

This is consistent with our account of the role of the informational needs of investors in an institution-oriented system; namely enough information to decide whether to take action using governance mechanisms. As a result of this stance, however, it was until very recently practically impossible for an investor to bring a civil claim based on a misstatement or omission in continuing disclosure.¹⁴⁹ This is in sharp contrast to the relatively broad liability imposed in the US under Rule 10b-5. However, in December 2006, a statutory cause of action for misstatements or omissions in continuing disclosure was introduced in the UK, albeit limited to a *scienter* standard.¹⁵⁰

¹⁴³ Council Directive 79/292/EEC of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing [1979] OJ L66/21, Schedule C ¶5(A). [Check UK implementation]

¹⁴⁴ Directive 2003/6/EC on Insider Dealing and Market Manipulation [2003] OJ L96/16, Art 6.

¹⁴⁵ FSA, DTR 2.2.

¹⁴⁶ [1990] 2 AC 605.

¹⁴⁷ *Ibid.* at 626, 631, 661-662.

¹⁴⁸ *Ibid.* at 662.

¹⁴⁹ *Ibid.* Whilst liability based on fraudulent misrepresentation might be available in theory, in practice the function of disclosure as aiding governance, rather than investment, would make it impossible to establish the necessary element of reliance: HM Treasury, Davies Review of Issuer Liability (‘Davies Review’), 18 (2007).

¹⁵⁰ Financial Services and Markets Act 2000, § 90A (introduced by Companies Act 2006).

If the periodic disclosure was limited to historic statements, how did institutional investors get access to forward looking information? The answer was through private conversations with management. Since the 1970s, it has been common practice for UK publicly-traded firms to engage in regular ongoing dialogue with their significant institutional investors.¹⁵¹ The larger the institution, the more willing management would be to give them time to engage and discuss prospects. Thus the relatively sparse verified public information was supplemented by much more open and frank communication between significant investors and the firm's managers. It continues to represent the norm in relation to UK institutional investors.¹⁵²

From the point of view of checking managerial agency costs, its efficacy depends on the establishment of reputation through repeated interactions—reputations of investors as appropriate recipients of information, and of managers as credible providers. Two illustrations may be offered from interview-based studies. Stapledon, who conducted interviews with institutional fund managers in the early 1990s,¹⁵³ reports that one interviewee explained:¹⁵⁴

“You are always looking and asking yourself: ‘What are they telling us is happening, and is that supported by factual information?’ If they’ve told you three times that something is going to happen, and it doesn’t happen, then you know the next time you take it with a pinch of salt. But if there’s somebody who tends always to deliver on what they say, then it gives you more confidence.”

¹⁵¹ In the early 1990s, this might typically mean a one-on-one meeting between senior management and each significant institutional investor each year, coupled with possible site visits by investors, and group meetings following public announcements (STAPLEDON, *supra* note 74, 102-106).

¹⁵² See, e.g., Institutional Shareholders’ Committee, *The Responsibilities of Institutional Shareholders and Agents—Statement of Principles*, updated June 2007, ¶¶ 3-4 (effective monitoring of investee companies requires establishment of ongoing dialogue; holding meetings with management as initial form of intervention in case of underperformance), available at <http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCStatementofPrinciplesJun07.pdf>; Hermes, *Hermes’ Approach to Engagement*, ¶ 3 (2004) (openness to discuss governance, strategic and capital structure issues with management), available at http://www.hermes.co.uk/pdf/corporate_governance/hermes%27_approach_to_engagement_250804.pdf.

¹⁵³ *Ibid.* at 55, 299.

¹⁵⁴ *Ibid.* at 104-105.

A more recent study investigating relations between UK boards and hedge fund investors reports a similar importance attached to reputational concerns.¹⁵⁵ In particular, the size of the participation, and the level of sophistication of the investor are said to be key factors:¹⁵⁶

“We make sure that the hedge funds are consistently well informed about the company and able to ask erudite and profound questions before granting a meeting with CEO/CFO.”

The system of frequent, informal bilateral communications thereby substitutes for more far-reaching mandatory disclosure of forward-looking MD&A statements in the US. However, the UK regime would appear to lend itself to selective disclosure. This could be understood in at least two senses. In a stronger form, it can be taken to mean that firms selectively disclose price-sensitive information to particular institutions. In a weaker form, no price-sensitive information is disclosed otherwise than by public channels, but differing levels of discussion and analysis are engaged with different investors. Since 1980, institutions receiving the stronger form of selective disclosure have been prohibited from trading on the information by insider dealing laws,¹⁵⁷ and Stock Exchange rules have required companies to make such information public without delay.¹⁵⁸ Rather, most companies time their investor meetings to *follow* the announcement of new information to the market, and the meetings focus on contextual discussion and ‘soft’ information. In any event, following a stock exchange clampdown in the mid-1990s, plus the more stringent *ad hoc* disclosure requirements regarding price-sensitive information, the scope for the stronger form of selective disclosure appears to have been greatly reduced. Selectivity in the weaker form, however, is still very much in evidence today.¹⁵⁹

Repeated private discussions with investors can permit, in an environment characterised by cohesion amongst institutional investors, the emergence of reputational constraints acting on

¹⁵⁵ Lintstock Ltd, Hedge Fund Engagement with UK plcs, 10-15 (2005).

¹⁵⁶ *Ibid.* at 13.

¹⁵⁷ Companies Act 1980, [refs].

¹⁵⁸ See, e.g., London Stock Exchange, Guidance on the Dissemination of Price Sensitive Information (1995); Listing Rules, ¶¶ 9.1-9.2 [check history]; see now FSA, MAR 1.4.2(2) (selective disclosure constitutes market abuse). However, given the difficulties with the enforcement of the criminal prohibition on insider trading, some such insider dealing has doubtless gone on: see STAPLEDON, *supra* note 74, 245 (‘it would be foolish to suggest that no insider trading occurs in the fund-management industry’); FSA, Review of the Listing Regime, Consultation Paper 203, 55 (2003) (acknowledging that market practice encompassed certain types of selective briefing of analysts, notwithstanding strict prohibition).

¹⁵⁹ See Lintstock, *supra* note 155, 13.

boards and their institutions, and between institutions and each other. These can allow the institutions to act effectively, with low transaction costs, if they are dissatisfied with a board's performance. Functional as this system may be, however, it also lends itself to the possibility of boards using selective disclosure as a reward for "loyal" investors, and thereby establishing a degree of entrenchment for themselves.

This review of differing disclosure requirements and liability standards in the two jurisdictions yields results consistent with our claim that in an environment in which the principal investors are institutions relying on governance mechanisms to control managers, mandatory informational requirements are lower, because all that is required is observability, rather than verifiability.

6. Enforcement Mechanisms

1. Formal Enforcement

The final dimension of difference concerns enforcement mechanisms. In a corporate governance system in which retail investors predominate, greater reliance is made on regulatory, as opposed to governance, mechanisms to control managerial agency costs. To be effective, regulatory mechanisms—that is, third-party intervention—must be supported by credible threats of enforcement. Conversely, where the predominant investor type is institutional, greater reliance is placed on governance mechanisms to control managerial agency costs. By their nature, these do not require the same degree of third-party enforcement; rather they simply require a credible threat of intervention by investors following underperformance. We would therefore expect, all other things being equal, to see more third-party enforcement occurring in the US than the UK.

This pattern is indeed observed, as regards formal enforcement by both private actors and public agencies. Consider first private litigation. In the US, fiduciary duty law suits are used as means of controlling egregious managerial misbehavior, and private litigation is facilitated by funding and procedural rules. A recent empirical study compares the incidence of private litigation of corporate law claims in the US and UK.¹⁶⁰ Over the period 2000-2006, US publicly-traded companies have an approximately 1/250 chance of one or more of their directors being subject to a lawsuit of this type generating one or more opinion, and 1/500 chance of being

¹⁶⁰ John Armour, Bernard S. Black, Brian R. Cheffins and Richard Nolan, Private Enforcement of Corporate Law: An Empirical Comparison of the US and UK, working paper (2007).

subject to a lawsuit that is not struck out at the first hearing.¹⁶¹ In contrast, over the period 2004-2006, no UK publicly-traded company was subject to a private lawsuit launched against its directors for breaches of corporate law duties that resulted in an opinion, and only one such claim was ever filed during this period, approximating to odds of 1/10,000.¹⁶² Similarly, private enforcement of securities law violations is frequent in the US,¹⁶³ whereas in the UK there are only one or two reported instances in which such claims have been brought since the early 1980s.¹⁶⁴

This relative dearth of *ex post* enforcement in the UK is not limited to private actions. As regards enforcement by public agencies, the US SEC brings far more enforcement lawsuits and imposes far higher aggregate penalties than does the UK's FSA, even controlling for the US' larger market capitalization.¹⁶⁵ To be sure, the UK's Takeover Panel does engage on a large scale with corporate actors, taking on average 368 cases a year over the period 1969-2006.¹⁶⁶ However, most of these interventions are of an *ex ante* variety: the Panel reviews information disclosure and advises parties about compliance in real time during an actual or potential takeover situation. The Panel imposes *ex post* sanctions much less frequently, on average in 6 cases a year over the same period.¹⁶⁷ Similarly, the UK's Financial Reporting Council, which oversees the quality of financial statements produced by publicly-traded UK companies, has only brought *ex post* court proceedings in 3 cases since 1991.¹⁶⁸

This is not to say that third party enforcement is likely never to occur in the UK. Indeed, even in a system in which governance mechanisms are the principal constraints on managers, there will need to be institutions supporting the allocation of decisional rights that allow such governance mechanisms to function—or, in economists' language, 'property rights need to be

¹⁶¹ However, the deterrent value of these lawsuits is perhaps questionable. In only 7 cases since 1981 have US outside directors had to pay out from their own pockets, as opposed to the suit being covered by their D&O insurance: see Bernard S. Black, Brian R. Cheffins and Michael Klausner, *Outside Director Liability*, 58 *Stanf. L. Rev.* 1055, ____-____ (2006).

¹⁶² Armour *et al.*, *supra* note 160.

¹⁶³ *Ibid.*

¹⁶⁴ John Armour, *Enforcement Strategies in UK Company Law: A Roadmap and Empirical Assessment*, working paper, 14 (2007) (two instances since 1980).

¹⁶⁵ John C. Coffee, *Law and the Market: The Impact of Enforcement*, working paper, Columbia Law School (2007).

¹⁶⁶ Armour, *supra* note 164, 27.

¹⁶⁷ *Ibid.*, 29.

¹⁶⁸ Data on FRC enforcement activity compiled from FRC Annual Reports, 1991-2006.

enforced'. UK courts do hear such actions.¹⁶⁹ Such rules require less information to be presented to the court, and do not require the decision-maker to have significant business expertise.¹⁷⁰ However, in other contexts—such as the control of inter-shareholder agency costs, for example—more intensive third-party enforcement may be required. The problem is how to do this in an environment where less information is available and courts and regulatory agencies have less experience of dealing with such matters directly. In short, regulatory institutions developed in the context of controlling managerial agency costs may create positive externalities in other fields; conversely, their absence may mean that substitutes need to be developed.

2. Reputation and Ostracism

The most powerful substitute for *ex post* formal enforcement which we see in the UK consists of reputation-based mechanisms. In short, parties who breach the rules are threatened with ostracism from the London markets.

It is well-known that where a group of parties have repeated interactions, sanctions taking the form of threats to withdraw the benefits of future interactions from non-cooperating parties can act as substitutes for external legal enforcement.¹⁷¹ Such mechanisms require a shared understanding amongst parties as to what constitutes 'sanctionable' conduct, and a means of discovering and disseminating information about breaches.¹⁷² The regulatory agencies in the UK perform this function. All of the principal agencies—the Takeover Panel (responsible for application, 'adjudication' and enforcement of the Takeover Code), the Financial Services

¹⁶⁹ See, e.g., *Mornington v Easier plc* [2005] EWHC 2578 (Ch) (shareholder seeking court requisitioned meeting to prevent incumbents frustrating attempts to requisition EGM to remove board of AIM-listed company); *Might SA v Redbus Interhouse plc* [2003] EWHC 3514 (Ch) (28.5% shareholder of company listed on LSE main list requisitioning meeting to remove board; seeking injunction restraining incumbents from Chairing meeting); *PNC Telecom plc v Thomas* [2002] EWHC 2848 (Ch) (17.6% shareholder requisitioning meeting to remove board of company listed on LSE main list: whether service of notice of requisition by fax effective).

¹⁷⁰ See Michael J. Whincop, *Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law*, 19 Oxf. J. Leg. Stud. 19 (1999); Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 Calif. L. Rev. 393 (2003).

¹⁷¹ It is one of the "folk theorems" of game theory that in the context of an indefinitely repeated game, there are multiple possible equilibria, some of which will induce co-operative behaviour in individual rounds. See, e.g. DOUGLAS G. BAIRD, ROBERT H. GERTNER & RANDALL C. PICKER, *GAME THEORY AND THE LAW*, at 172-173 (1994); ERIC RASMUSEN, *GAMES AND INFORMATION*, at 123-126 (2nd ed. 1994).

¹⁷² Otherwise there are significant potential problems relating to false accusations being launched in order to gain private advantage against competitors.

Authority (responsible for prospectus and circular scrutiny, enforcement of the Listing Rules, and sanction of , and the Financial Reporting Council—list the threat of censure amongst their armory of potential sanctions, and exercise it periodically.¹⁷³ The Takeover Panel, which was the pioneer in this regard, provides a very good illustration. The Panel was established in 1968 in response to widely-perceived problems occurring in relation to bidder and target tactics during the takeover wave of the late 1960s. Its guiding code of principles, the *City Code on Takeovers and Mergers*, drew on and developed an earlier set of best practice guidelines, the *Notes on the Amalgamation of British Businesses*, which had been promulgated in 1959 by a working party chaired by the Bank of England. The existence and promulgation of the *Notes* satisfied the first of the preconditions we have articulated above for the operation of reputational sanctions—namely, a shared statement of what constituted sanctionable conduct. However, what was lacking was a disinterested, and therefore credible, mechanism for the identification and transmission of information about breaches. Until an independent advisory and investigative body—the Takeover Panel—was established, this condition was lacking.

However, merely ‘naming and shaming’ is not enough to sustain desired conduct. Individuals may still derive private benefits from cooperating with the shamed party. Indeed, the Takeover Panel’s first year (1968-9), in which its sole sanction was public censure, was widely perceived to be a failure because of several flagrant breaches of its orders by recalcitrant parties. To overcome this problem, the Panel in 1969 co-opted the relevant trade and professional associations of stockbrokers, investment banks, insurance companies, mutual fund managers, and the London Stock Exchange itself. This was an alliance of reputation-pooling organizations, who had a shared interest in the reputation of the takeover system as a whole. Each agreed to impose sanctions, including the possibility of exclusion, on any member attracting an adverse ruling from the Panel. This model was derived from that already used by the London Stock Exchange to enforce its listing rules, and by the Bank of England in banking standards. A similar structure was subsequently adopted when other Self-Regulatory Organizations (‘SROs’) were set up in the City of London during the 1980s.

Reputational-pooling guilds and trade associations, using the threat of ostracism as a sanction, have had well-documented success in a number of different business contexts, both as

¹⁷³ The Takeover Panel has issued approximately 1.2 public censures *per annum* relating to breaches of the Takeover Code during the period 1987-2006 (Armour, *supra* note 164, 29). The Financial Reporting Council has issued approximately 4.8 such censures *per annum* over the period 1991-2007 in relation to financial statements published by UK publicly-traded companies (FRC Annual Reports, 1991-2007). [Add FSA data].

substitutes for, and superior alternatives to, formal law.¹⁷⁴ In order to make denial of future business credible, they use an iterated sanction mechanism: members who breach the rules are ostracized, and one of the rules is rule that no member may deal with an ostracized member. Applied to the context of the UK's regulatory environment, a ruling from the Panel that a party had breached the Code could in sufficiently serious cases be relied upon to provoke, in the case of a professional, exclusion from the ability to continue to practice in London, or in the case of a firm, de-listing from the London Stock Exchange. A similar stance is now adopted by the FSA, which acts as a comprehensive gatekeeper both to individuals and firms operating in any investment related business (including most institutional investors and their fund managers), through the grant of 'fit and proper person' status, and to firms wishing to list on the main list, through the FSA's function as UK Listing Authority. Not only does this mechanism serve directly to police professionals and listed firms, but it also recruits them as gatekeepers for others. An example of this is found in the Takeover Panel's statement in relation to two financiers involved in numerous Code breaches in relation to an attempted takeover in 1991:¹⁷⁵

'In the Panel's view neither Mr Drummond nor Mr Prentice nor any company which is in practice, directly or indirectly, controlled by either or both of them is likely to comply with the standards of conduct for the time being expected in the United Kingdom concerning the practices of those involved in takeovers and mergers. Therefore ... persons or firms authorised to conduct investment business are prohibited from acting for Mr Drummond or Mr Prentice or companies which are ... controlled by either or both of them in connection with transactions regulated by the City Code ...'

By threatening sanctions for any regulated party who assists the ostracized financiers, it excludes the latter from any future participation in the takeover market. Thus the only type of party who is unlikely to be deterred by the threat of such sanctions is a true 'one-shot player', who derives a sufficiently large payoff from a single breach as never to have to return to the marketplace.

The UK's reliance on reputation and gatekeeper mechanisms means that its regulators have access to sanctions that are, as compared to *ex post* litigation, relatively disproportionate and relatively cheap to impose. Disproportionate in the sense that public censure or cold-shouldering cannot be tailored to fit the gravity of the breach to the same degree as can legal sanctions; cheap

¹⁷⁴ Avner Greif (11th century Maghribi traders—guild mechanisms substitute for formal law), Lisa Bernstein (diamond merchants; cotton and grain associations—guild mechanisms chosen in preference to formal law owing to superior dispute-resolution efficacy).

¹⁷⁵ PANEL ON TAKEOVERS AND MERGERS, MR ANDREW P. DRUMMOND AND MR ROBERT D. PRENTICE: RE DUNDEE FOOTBALL CLUB PLC, PANEL STATEMENT 1992/9, 15.

in the sense that no legal proceedings are required, simply a public announcement. Under such circumstances, it may be rational for an enforcement agency to expend a greater share of resources on detection of infringements, rather than sanctioning them. Once an infringement has been detected, the agency may offer to hold any censure in suspense, provided that the infringement is not repeated.¹⁷⁶ Thus the greater the level of prior infringements by any actor, the more credible the threat of sanction, and hence the more effective the deterrent. This account squares with the self-declared ‘compliance oriented’ enforcement culture at UK agencies such as the Takeover Panel, the FSA and the FRC.

[Summary para]

IV: Two Systems and their Convergence in the Metropolitan Firm

1. The Argument Thus Far.

The stylized account of ownership structure throughout the world compares the diffuse ownership systems of the US and the UK with the concentrated ownership systems that prevail elsewhere in the world. The argument thus far has been that there are two important variants of diffuse ownership (meaning two variants of the Berle-Means corporation): retail systems and institutional systems, which differ critically on the cost barriers to collective shareholder action and thus on the appropriate mechanisms for the control of managerial agency costs. Separation of ownership and control through retail ownership means that individuals (as record holders and beneficial owners) are the voters. For such shareholders, however, passivity is the dominant strategy in the exercise of the reserve shareholder power. Separation through institutional ownership means that institutions, rather than individuals, are record holders and beneficial owners and thus are the voters. Individuals own claims against the institutions, not stocks themselves. Because institutions can act collectively at lower cost than individuals, passivity is no longer a dominant strategy. These diffuse ownership variants correspond in historically important ways to the United States and the United Kingdom, as section III demonstrated.

Different forms of diffuse ownership will produce different regulatory regimes. Shareholder voting is of limited utility in the control of managerial agency costs in a retail system, which will look instead to intensive public and private enforcement of extensively elaborated legal duties. Extensive (and enforced) mandatory disclosure is a complementary element in the legal enforcement of these duties. Robust disclosure also facilitates non-legal

¹⁷⁶ See Paul Fenn and Cento Veljanovski, *A Positive Economic Theory of Regulatory Enforcement*, 98 Econ. J. 1055 (1988).

enforcement of these duties: (1) directly, through the revelation of firm specific information, (2) indirectly, through stock market prices that impound information about agency costs and (3) indirectly, through the support of stock market liquidity that reduces exit cost of dissatisfied retail investors .

By contrast, an institutional system seeks to control agency costs through a governance regime that empowers institutions as shareholders but subjects them to reputational constraints against intra-shareholder opportunism. The regime is supported by firm-level disclosure of two kinds: mandatory public disclosure of firm-specific information and selective private disclosure of firm-specific information. The regime is also supported by robust mandatory disclosure about shareholder behavior, particularly ownership levels and intentions, to help mitigate the risks of intra-shareholder opportunism. The institutional system will not come under pressure to elaborate legal duties to control agency costs; similarly, it will create a low-intensity enforcement regime.

An institutional system critically depends upon repeat play and various other observability conditions to sustain reputation. These reputation channels run in two directions: between the firm (through its officers and directors) and the institutions, and among the institutions themselves. Reputation sustains the low cost coordination among shareholders that supports a successful governance regime. Reputation also sustains the firm's willingness to reveal competitively-sensitive information selectively and privately to institutional holders. Such disclosure can make an institution a better governance actor but risks premature public release that would be costly to the firm. There are several elements that facilitate the creation and maintenance of reputation. (i) Geographic proximity of the institutions makes it easier for the actual agents who run the institutions to observe one another and decide whether trust is warranted. It also gives the regulator greater access to informal and formal mechanisms to enforce anti-opportunism rules. (ii) Similarity of the institutions, including the time horizon over which results are measured, makes it easier to evaluate whether behavior is cooperative or opportunistic and of course makes agreement easier on what measures to take. (iii) Frequently required shareholder approval plays an important role as well. It creates the necessary governance channel of course, but it also provides multiple learning opportunities as well as multiple occasions for institutions to observe one another's behavior. Greater skill in governance intervention by lead institution or group that is credibly non-opportunistic will lower the cost of cooperation .

2. The Transformation of Ownership in the US and UK

Our claim is that an increasingly large world-wide group of major public corporations that account for a significant fraction of world GDP will come to exhibit an ownership structure that combines elements of both the retail and the institutional models, what we call “metropolitan firms.” We see this in the case of both the US and the UK. Share ownership patterns have, on both sides of the Atlantic, changed quite dramatically since the early 1990s. Whilst the rise of institutional investors in the US is a phenomenon that has long been understood, it has gathered momentum in the 1990s and 2000s, leaving the retail investor as an increasingly endangered species (Figure 1). The scale economies of institutional investing mean that the fraction of institutional ownership is even higher in the largest firms. Not only this, but the types of ‘institutional’ investor have become more varied. In addition to the familiar pension funds (public and private) and mutual funds, first hedge funds and now sovereign wealth funds have joined the investment party.

At the same time, the UK’s ownership patterns have also been changing. Amongst domestic institutions, hedge funds have elbowed their way to the front of the governance arena domestically, just as tax changes have weakened the significance of pension funds. Simultaneously, domestic institutions as a group have been replaced by their overseas counterparts. The geographic dispersion and diversity of these investors undercuts the conditions necessary to create and sustain reputation, on which the UK institutional system depends. A Hong Kong mutual fund, a German special situations hedge fund, a US public pension fund, a Chinese sovereign wealth fund, a Russian conglomerate, a UK “market neutral” hedge fund, and a Swiss private equity fund will not necessarily all play by Association of Investment Trust Company rules.

In this new landscape, it becomes increasingly meaningless to speak of ‘institutional’ investors. Investors who are *not* institutional are an endangered species; investors who *are*, on closer examination, share fewer and fewer common traits. The emerging pattern of ownership is one in which investors are sophisticated professionals who manage other people’s money, but who do pursue such a wide range of different investment strategies as to have potentially limited opportunities for repeated interaction with other significant investors in any given firm. This heterogeneity of investors’ time-horizons and incentive structures may follow through to quite different ‘styles’ in their monitoring strategies and preferences regarding governance.¹⁷⁷

¹⁷⁷ See Henrik Cronqvist and Rüdiger Fahlenbrach, *Large Shareholders and Corporate Policies*, Rev. Fin. Stud. advance access (2008), doi:10.1093/rfs/hhn093.

3. The Transformation of Ownership Elsewhere

Elsewhere in the world, diffusely-owned firms are already metropolitan firms, in the sense that their institutional owners are geographically dispersed and diverse.¹⁷⁸ US mutual funds investing overseas prefer to invest in larger firms with more diffuse ownership.¹⁷⁹ They also exhibit a preference for mechanisms that assist in overcoming managerial agency costs, including country-level protection of shareholder rights, and firm-level accounting transparency.¹⁸⁰

Some firms currently with concentrated ownership will become metropolitan firms. As the scope of enterprise becomes world-wide, the increasing equity base of large firms means that blockholder control requires a growing equity stake that entails increasingly unattractive financial risks.¹⁸¹ As the necessary equity stake increases, so do risk-bearing costs and the loss of liquidity. Diversification becomes increasingly infeasible. Compensatory pecuniary private benefits of control would require a scale that is inconsistent with increasing business complexity and size. Compensatory non-pecuniary benefits would have to reach remarkable levels in light of the increasing financial risks.¹⁸² This predicts for more ownership diffusion.¹⁸³

¹⁷⁸ Cite to evidence.

¹⁷⁹ See Magnus Dahlquist and Göran Robertsson, *Direct Foreign Ownership, Institutional Investors, and Firm Characteristics*, 59 J. Fin. Econ. 413 (2001) (US mutual funds investing in Sweden exhibit a preference for larger firms with relatively dispersed stock ownership); Miguel A. Ferreira and Pedro Matos, *The Colors of Investors' Money: The Role of Institutional Investors Around the World*, 88 J. Fin. Econ. 499 (2008).

¹⁸⁰ See Reena Aggarwal, Leora Klapper, and Peter D. Wysocki, *Portfolio Preferences of Foreign Institutional Investors*, 12 J. Bank. & Fin. 2919 (2005); Ferreira and Matos, *ibid*.

¹⁸¹ This is the result of institutional diffuse ownership as opposed to retail diffuse ownership. That is, if almost all shareholders are passive (as in a pure retail system), a would-be controller needs only a relatively small block that may even decrease as firm size increases. Someone who owned 5 percent of GM in the 1950s, for example, might in some sense be said to have “control.” But if the owners are institutions, then control is certain only at 50 percent, though “reliable” control should be feasible at a lower fraction, but that fraction will not necessarily decrease as firm size increases.

¹⁸² Gilson (2006) emphasizes the distinction between pecuniary and non-pecuniary benefits.

For concentrated ownership systems there is an analytically useful distinction between “controlling blockholder” regimes and “controlling controller” regimes, based on the different ratio between voting rights and cash flow rights. In a controlling blockholder regime, where the ratio is one, maintenance of control is linked to an ownership block whose value must generally increase in firm size. This presents the problems discussed in the text. In a controlling controller regime, exemplified by ownership pyramids or multiple class common, the ratio can be significantly less than one. In a controlling controller system if the ratio is allowed to decrease, the controller’s required equity investment need not increase in firm size. But given concerns about the likely inefficiencies of this form of organization because of the stark (and potentially increasing) incentives mismatch between the controller and the public

Diffusion is almost certain to be institutionally based, if only because individuals regard themselves as less capable to make investment decisions across the international universe of companies and to handle trading and settlement systems outside their home countries.

4. The implications of the transformation of ownership in the US and UK

Whilst share ownership patterns in the US and UK probably now look more similar to each other than at any time since World War II, the regulatory systems are still quite different. Whilst both are functionally adaptive for dispersed stock ownership, we believe that each is keyed to features of their respective *ancien regime* of ownership. Change in the mix of mechanisms to control agency costs is, therefore, to be expected. It is our expectation that the Berle-Means corporation of the future will, if it is located in the US or UK, be characterized by a mixture of the mechanisms today employed in each of the two systems to control agency costs.

The mismatch of the ownership structure of the metropolitan firm to the corporate governance systems of either the US or the UK suggests the desirability of reform and evolution. The optimal system looks to be a hybrid that combines elements of the two regimes, meaning elaborated legal duties, robust mandatory disclosure, strong shareholder governance rights, checks against intra-shareholder opportunism, and reasonably intense enforcement. The question is, if such a hybrid system is indeed more adaptive to the economically case of the metropolitan firm, how do we get there from here?

There are three mechanisms of change modes of competitive pressure that might lead to change in the US or the UK, namely lobbying by domestic interest groups, regulatory competition, and ‘yardstick’ competition. The history of both the UK and US systems illustrate the importance of domestic political economy. In the UK, cohesive domestic institutions successfully captured the regulatory agenda, spurring the development of many governance mechanisms suitable for controlling managers by diversified institutional shareholders.¹⁸⁴ In the

equity suppliers, it seems improbable that this form of concentrated ownership system will be heralded as a governance solution for the largest world-wide firms.

¹⁸³ The increase of ownership diffusion in firm size is consistent with LaPorta et al, who find, in a cross-country ownership survey of the 20 largest public firms (by market capitalization) in 27 countries, that the incidence of diffusely held firms increases as the ownership block criterion shifts from 10 percent to 20 percent, i.e., as the equity investment presumed necessary to retain control increases. (JF April 1999, pp. 492-93 Table II). Similarly, for “medium” public firms, they find fewer that are diffusely held, presumably because the necessary equity investment to retain control is smaller. (Id. at 494-95, Table III).

¹⁸⁴ See John Armour, *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment*, in RATIONALITY IN COMPANY LAW: ESSAYS IN HONOUR OF DAN PRENTICE (John Armour & Jennifer Payne, eds.), 71 (2009).

US, the diffusion of retail investors set up a political economy that was favourable to managers.¹⁸⁵ Notwithstanding their heterogeneity, the rise of institutional investors has put shareholder governance rights to the forefront of the political economy of corporate governance in the US.

Shareholder passivity is no longer the dominant strategy and US institutional investors are bridling at the limits of the present system. This is being spurred by interacting developments at the firm, state, and federal level. At the firm level, institutional investors have sponsored increasingly-ambitious bylaw amendment proposals which have removed staggered boards, introduced majority rather than plurality voting for unopposed director elections and pushed for reimbursement of proxy expenses.¹⁸⁶ Delaware's courts and legislature have been receptive to this push. In *CA, Inc. v. AFSCME Employees Pension Plan*,¹⁸⁷ the Delaware Supreme Court opened the door to bylaw amendment proposals effectively requiring the corporation to reimburse the expenses of successful short slate proxy challengers. In August 2009, new legislative provisions came into force explicitly permitting Delaware corporations to provide, through bylaw amendment, for shareholder access to the corporate proxy and proxy expense reimbursement.¹⁸⁸ At the Federal level, the SEC's recent e-proxy rules lower the costs of proxy solicitation,¹⁸⁹ and the still-controversial proposed Rule 14a-11 will give shareholders in all US public companies the right to nominate a short slate on the corporate proxy.¹⁹⁰

A second dimension relates to the control of executive compensation, a story which is playing out largely at the federal level. On the one hand, momentum is gathering for the introduction of UK-style 'say on pay'. The calls from institutional investors have been given a powerful populist tailwind by the financial crisis.¹⁹¹ The Corporate and Financial Institution

¹⁸⁵ ROE, *supra* note xx.

¹⁸⁶ See Marcel Kahan and Edward B. Rock, *Embattled CEOs*, working paper, NYU Law School/Penn Law School (2008).

¹⁸⁷ 953 A. 2d 227 (Del. 2008).

¹⁸⁸ DGCL §§ 112-3. These statutory provisions clarify that the inclusion of such provisions in corporate bylaws does not *per se* conflict with the board's exclusive management jurisdiction under § 141(a).

¹⁸⁹ 17 CFR §§ 240.14a-16, 240.14a-17.

¹⁹⁰ See SEC, Facilitating Shareholder Director Nominations, Release Nos. 33-9046, 34-60089 (2009).

¹⁹¹ Ironically, this seems to be an entirely inapt policy prescription to draw from the crisis, at least as regards financial institutions. The financial institutions at which CEO pay was *most* responsive to shareholders suffered worst in the financial crisis: see Rüdiger Fahlenbrach and René Stulz, *Bank CEO Incentives and the Financial Crisis*, Dice Center for Research in Financial Economics Working Paper 2009-13 (2009).

Compensation Fairness Act of 2009 will, if successful in the Senate, mandate a precatory resolution.¹⁹² The TARP legislation, whilst applicable to only a handful of large (mainly financial) firms, has cast an intentionally long shadow, and appears to be spurring voluntary changes in governance practices and the introduction of say-on-pay resolutions.¹⁹³

[Reasons to doubt the desirability of having institutional investors dominate the political economy: (1) unlike the UK's historical experience, modern institutions are uncohesive and heterogeneous. This implies a greater need for restrictions on intra-shareholder agency costs, to do the work which would otherwise be done by reputational constraints. However, heterogeneous institutions are more likely to form effective coalitions over increases in shareholder rights than over how to control intra-shareholder agency costs. Hence there is a risk of corporate control being pushed away from managers' hands to a degree that is sub-optimal, given uncohesive institutions. Arguably this may have happened in the UK: witness recent proposals to restrict voting rights to 'long term' investors and/or to make hostile takeovers more difficult. (2) Where institutions do form coalitions over reform, these may be subject to similar biases as are exhibited in their investment strategies: 'herding' into proposals for reform which are believed to be 'winners' for controlling agency costs, even if the evidence supporting this belief is weak. Arguably much of the fervor for corporate governance reforms over the past few years—in particular, as regards board structure—exhibits this problem.]

Regulatory competition works in the process of matching the demand side for better law with the supply side. There will be a growing group of firms moving from concentrated ownership to metropolitan ownership whose home country governance system is not best suited to a diffusely-owned firm. These firms may be able to improve their governance by opting into another country's system, either through a change in domicile and reincorporation or through cross-listing. Conceivably even firms now incorporated in the US or the UK, as the case may be, could seek to reincorporate or to cross-list. In certain respects each country is highly sensitive to the locational choice, as demonstrated by the debate over an apparent shift in initial public offerings from the NYSE/NASDAQ to the LSE/AIM market.

[more]

¹⁹² This is a revived version of the Shareholder Vote on Executive Compensation Act of 2007, introduced to the Senate by then-Senator Barack Obama.

¹⁹³ See, e.g., *Firms Back Plans to Change Pay Policies*, Wall Street Journal, September 22, 2009. [note also e.g. Microsoft voluntary adoption of say-on-pay].

Yardstick competition [citizens of Country B say, Country A has a better system; let's copy it. It's not a competition that occurs at the individual firm level, but rather mediated through politics.]

[more]

5. What is the right mix?

The UK regulatory system works best in the case of *cohesive* institutional ownership in which reputation among shareholders is sustainable through the interaction of a complementary set of local arrangements and other local institutions and the regulator has ready access to important actors. But the emerging metropolitan firms will reflect *uncohesive* institutional ownership, which will fit uneasily with UK-style governance and enforcement. As US shareholders gain power, however, policymakers might do well to consider also some of the other mechanisms employed in the UK to constrain the self-serving use of this power—that is, *intra*-shareholder agency costs. An initial point to understand here is that the traditional reputational constraints that have served to restrain such self-serving behavior in the UK are weakened in the context of uncohesive institutional investor ownership.¹⁹⁴ US commentators should not, therefore, assume that the UK's relatively orderly historical experience of shareholder voice will be replicated. Rather policymakers might do well to consider other mechanisms that may be used to control such costs.

First, greater reliance on *ex ante* voting by disinterested shareholders might substitute for court review of related party transactions. At present, a transaction with a controlling shareholder—if holding less than an absolute majority then determined as a matter of fact—will likely invoke the strictures of entire fairness review,¹⁹⁵ whereas a transaction with a potentially influential, but not controlling shareholder—say with a 5-10% stake—will invoke only a disclosure obligation.¹⁹⁶ Given the sophistication of modern (institutional) shareholders, such votes are now more feasible.

Second, enhanced block disclosure triggers are worthy of careful consideration—lower threshold percentages, shorter filing times, and clarity of application to derivatives. The primary benefit is to inform other investors of significant positions, which helps to establish coalition formation, anticipated voting intentions and, where salient, positions contrary to other

¹⁹⁴ Cf Black, *Agents Watching Agents*, *supra* note ___, ___-___.

¹⁹⁵ *Weinberger v UOP* ;

¹⁹⁶ Regulation S-K, Item 404(a), Instruction 7.b.i.

shareholders' interests. This in turn could be combined with judicial assessment of shareholders' conflicted interests when voting.

[to follow]

[CONCLUSION]

Table 1 : Stock Market and Firm Ownership Characteristics, Selected Countries

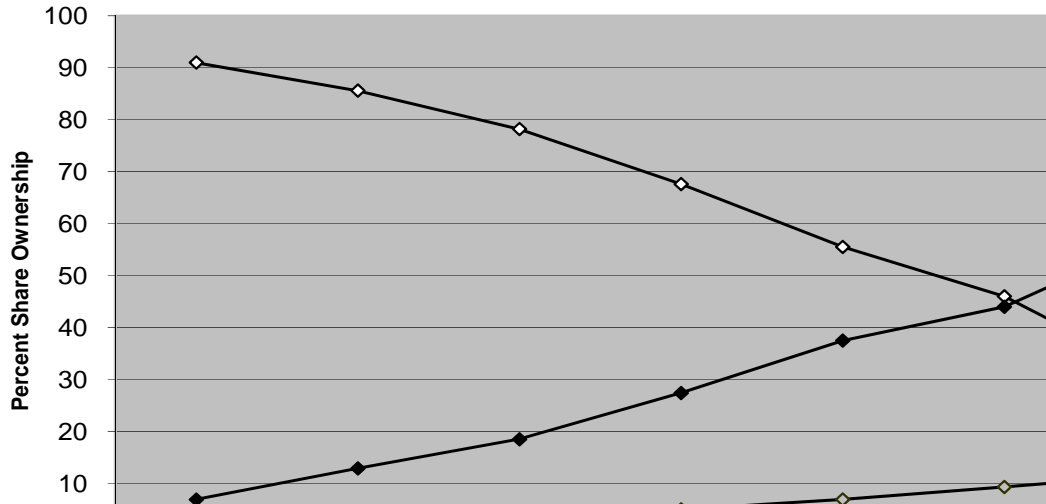
Country	GDP, 1995 (US\$bn)	Mkt cap, 1995 (US\$bn)	Population of listed firms, 1996	Proportion of largest 20 firms without 10% block, 1995	Median block size, all firms (%), 1995
Austria	239.56	32.51	106	0.05	63
Belgium	284.32	104.96	139	0.00	54
Finland	130.92	44.14	71	0.15	54
France	1570.26	522.05	686	0.30	63
Germany	2522.79	577.37	681	0.35	66
Hong Kong	144.23	303.71	561	0.10	49
Ireland	67.10	25.84	76	0.45	37
Italy	1126.04	209.52	244	0.15	65
Japan	5244.25	3667.29	2334	0.50	27
Norway	147.97	44.59	158	0.05	50
S Korea	517.19	181.96	760	0.40	37
Spain	595.75	197.79	357	0.15	52
Sweden	250.64	178.05	229	0.00	48
Switzerland	314.80	433.62	213	0.50	54
UK	1133.63	1407.74	2433	0.90	36
US	7342.30	6857.62	8479	0.80	50

Sources: GDP and market capitalization data are from the World Bank's *World Development Indicators* database; Population of listed firms is from dataset for 'What Works in Securities Laws' made available by Andrei Shleifer at <http://www.economics.harvard.edu/faculty/shleifer/dataset>; Proportion of largest 20 firms without 10% block is from La Porta *et al, supra* note 21, 493; Median block size is from Holderness, *supra* note 28, 44 (Table 4).

Table 2: Two Varieties of Dispersed Ownership

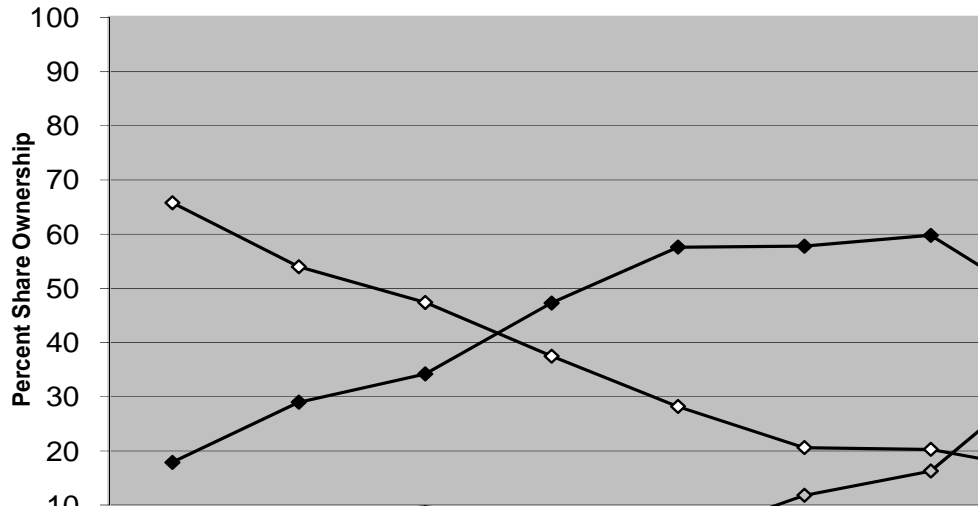
		US	UK
Shareholder characteristics	Complementary legal mechanisms		
Historically predominant shareholder type		Retail	Institutional
Ability to take governance decisions		Weaker	Stronger
Principal controls on managers		Regulatory	Governance
Potential for intra-shareholder opportunism		Lesser	Greater
Constraints on intra-shareholder actions		Weaker	Stronger
Information Requirements		Verifiable	Observable
Disclosure Obligations		Stronger	Weaker
Repeated interactions		Unlikely	Likely
Enforcement mechanisms		Formal	Informal

Figure 1: Share ownership patterns in the United States, 1950–2006¹⁹⁷



¹⁹⁷ BOARD OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS IN THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS, 1945-1954; 1955-1964; 1965-1974; 1975-1984; 1985-1994; 1995–2006, at 82 tbl.L.213 (2007), available at <http://www.federalreserve.gov/releases/z1/Current/data.htm>. Figures are expressed as percentages of total holdings at market value.

Figure 2: Share ownership patterns in the United Kingdom, 1957–2006¹⁹⁸



¹⁹⁸ OFFICE FOR NAT'L STATISTICS, SHARE OWNERSHIP: A REPORT ON OWNERSHIP OF SHARES AS AT 31ST DECEMBER 2006, at 9 (2007); John Moyle, *The Pattern of Ordinary Share Ownership: 1957–1970*, at 6–7 (Univ. of Cambridge Dep't of Applied Econ., Occasional Paper No. 31, 1971).

Figure 3: US mutual fund and hedge fund assets under management/ \$bn

