The Political Roots of American Corporate Finance

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In 1990, two of General Motor’s largest institutional shareholders, unhappy with the company’s declining market share and profits during the 1980s, sought to talk to GM’s leaders about a successor to the retiring CEO. GM’s senior managers rebuffed the shareholders. They could do that because the two large stockholders each owned less than 1% of the company’s stock.

How such a corporate ownership structure—many shareholders with small percentage holdings and, until recently, little voice in governance—came to be the dominant form of large business enterprise in the United States is usually understood as a purely economic story, one of business adaptation to economies of scale and investor diversification. The reigning explanation of U.S. corporate ownership structure continues to be the one provided over 60 years ago by Adolf Berle and Gardiner Means in their classic, The Modern Corporation and Private Property. According to Berle and Means, economies of scale made possible by new technologies required U.S. companies at the turn of the century to become so large that their enormous capital needs could be satisfied only by selling stock to many outside investors—investors who, by and large, wanted diversified portfolios. Ownership was thus dispersed, and this dispersion shifted decision-making power over the firm from shareholders (or, more precisely, shareholder-managers) to professional managers. This had benefits: it facilitated the exit of company founders and their heirs, professionalized U.S. management, and set the stage for large mergers. But, as Berle and Means warned, the separation of ownership from control also had offsetting costs stemming from weakened managerial incentives and accountability.

What Berle and Means failed to foresee were the many corporate governance mechanisms that were devised by both corporate insiders and outside investors to reduce such “agency costs”—things like proxy fights, hostile takeovers, incentive compensation plans, and, more recently, active outside directors prodded by institutional investors. The continued domination of the large public corporation in the U.S. suggests that such governance mechanisms, coming on top of intense competition in American product markets, worked to minimize the problems from the separation of ownership from control. For if the U.S. system had failed to “adapt” in a way that solved this governance problem, the current U.S. ownership structure would have been supplanted by a more efficient alternative. Survival implies efficiency—or at least greater efficiency than available alternatives.

In 1994, I published Strong Managers Weak Owners: The Political Roots of American Corporate Finance, in which I argued that this explanation, although correct as far as it goes, is incomplete. Economics alone cannot fully account for the evolution of the U.S. corporation into its present form. Politics, in the form of laws and regulations affecting commercial banks and other financial institutions, played a key role in fragmenting stock ownership beyond what was required to have big firms and well-diversified investors. From the middle of the 19th century onward, both state and federal laws restricted the growth and activities of the largest American financial institutions. U.S. commercial banks were prevented from branching nationally, and thus they lacked both the size and the information networks to fund big pieces of the capital required by the large American firms emerging at the end of the 19th century. Banks’ products and portfolios were also restricted—most important, banks were barred from the securities business and from owning stock. U.S. insurance companies were barred from buying stock for most of this century. Mutual funds, thanks

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to rules established in the 1930s and 1940s, cannot easily devote their portfolios solely to big blocks; and they face legal problems if they go into the boardroom. And, finally, pension funds cannot take very big blocks without structural and legal problems; the big private pensions are under managerial control (not the other way around) and ERISA rules make it more comfortable for pension managers to avoid big blocks than to take them.

The rules that restricted the size and scope of U.S. financial institutions were neither random nor economically inevitable. While the public interest goals of protecting financial institutions explain some rules, they do not explain all of them. Two major forces lay behind many of the restrictions: American populism, with its profound distrust of large private accumulations of power, and interest group politics. There were businesses and individuals—mostly local bankers—who gained from the early fragmentation of U.S. financial institutions. These winners in the political process had a large voice in Congress, in part because their private goals happened to line up well with popular sentiment.

The environment in which the large American firm evolved was conditioned by more than engineers’ requirements for huge economies of scale and investors’ demand for diversification. It was also a political environment that precluded very large-scale finance and raised the costs to financial institutions of participating in the governance of large firms. A richer story of evolution toward efficiency must account for political influences that shunted the large firm’s evolution down some paths and not others.

The Limits of Economics in Explaining Corporate Ownership

Corporate finance and corporate governance are primarily economic matters. The financing goal is typically to secure funding for the corporation at the lowest possible cost; the governance goal is to maximize the value of the firm to its owners. Given these economic priorities, politics and law are rarely viewed as fundamental influences on the organization of finance and corporate governance. But the structure at the top of a nation’s companies—the place where the board of directors, shareholders, and senior managers interact—is the outcome not just of economic evolution toward efficiency, but of political developments such as laws and regulations that limited the range of adaptive possibilities.

Of particular importance are historical events that influenced, and occasionally dictated, the ways in which financial intermediaries—particularly banks and insurance companies—channelled savings from households to firms. America’s historical aversion to private concentrations of economic power sharply limited the size and activities of its financial institutions. Such restrictions in turn influenced how stock (and debt) has been owned in the U.S., in large part by making it costly—if not illegal—for such institutions to own large blocks of a single company’s stock or play an active role in corporate governance.

To put the same thought a little differently, U.S. law and politics historically denied firms and investors the use of certain corporate governance tools, and so the American governance system evolved in ways that enabled them to make the best use possible of the other available tools. Corporate managers and investors used the tools at their disposal. Had more tools been available, some companies may well have chosen a different mix to make themselves as efficient as possible.

That politics affected the forms of corporate ownership seems likely. But did these political forces on U.S. corporate ownership structure also affect corporate efficiency and security values? Even if U.S. corporations and their investors successfully “adapted,” it seems plausible that American laws reduced corporate efficiency and increased the cost of capital for some firms in some periods of U.S. history. Adaptation, after all, has costs. And, although the evidence is uncertain, it also seems plausible that denying use of a potentially effective governance tool could have continuing costs for some American firms.

In the next part of this article, I summarize the considerable evidence that U.S. politics, laws, and regulations influenced the forms of ownership and top-level governance of the American corporation. Evidence of large increases in costs of capital is harder to come by, and less persuasive. Nevertheless, in the second half of the article, I discuss three potential problems—(1) monitoring (or “agency”) costs, (2) information costs, and (3) costs of coordinating long-term investments involving different parties—that could each raise the cost of capital for companies with fragmented ownership. By foreclosing the possibility of concentrated ownership, American politics denied U.S. companies one of the governance tools that could have helped to control these problems.
I close by offering some policy prescriptions. There is enough basis for arguing that concentrated ownership could at times be helpful that those restrictive rules lacking a policy justification ought to be pulled back. The reason to do so is not to favor one governance tool over another, but to encourage both ownership structures. Competition among alternative governance systems within the U.S. economy has the potential to increase the efficiency of American firms.

POLITICAL ROOTS

Political influences shaped American financial institutions and, in the process, American corporate finance and ownership patterns. Begin by looking at the large U.S. corporation as it emerged at the end of the 19th century. Coming near the close of the Second Industrial Revolution, this period saw remarkable advances in technology. One major consequence of the new technologies was enormous economies of scale, which meant that the cheapest production accrued to the firms with the largest operations. Among industrialized nations at the time, only America had a continent-wide economy with low internal trade barriers; and thus it alone provided a sufficiently large market for those enterprises that could achieve large-scale efficiencies.

But achieving the tremendous output necessary to realize the new scale economies required huge capital inputs to build the manufacturing facilities and the distribution system. Where could that capital come from? Much of it came from internal growth and retained earnings, some of it came from investors. Individuals, even when assembled into small groups, lacked sufficient capital to fund such undertakings. As Alfred Chandler described the railroads, the first of the modern business enterprises,

Ownership and management soon separated. The capital required to build a railroad was far more than that required to purchase a plantation, a textile mill, or even a fleet of ships. Therefore, a single entrepreneur, family, or small group of associates was rarely able to own a railroad. Nor could the many stockholders or their representatives manage it. The administrative tasks were too numerous, too varied, and too complex. They required special skills and training which could only be commanded by a full-time salaried manager. Only in the raising and allocating of capital, in the setting of financial policies, and in the selection of top managers did the owners or their representatives have a real say in railroad management.

Even John Rockefeller, the richest man in America, ended up owning only a fraction of Standard Oil. New technologies allowed for vertical integration of several steps in production and distribution; transactions that once occurred across markets—making raw materials in one firm, manufacturing them into a final product in another, and distributing them in yet another—were brought inside a single firm, with managers visibly coordinating the steps of production. Managers had to avoid shortages at each stage of production and ensure a smooth flow from raw material to final sale. Management thus became an even more critical determinant of the success or failure of large enterprises.

Eventually these new large-scale enterprises had to draw capital from many different shareholders whose holdings tended to be small in relation to the size of the enterprise. Although the early growth was financed by the founders’ own capital and by retained earnings, a growing firm’s capital requirements tended to outstrip its ability to finance itself from its own earnings. Commercial banks would often lend capital to fund part of this growth, but banks could not play a full range of roles because of their size (national banks were limited to a single location) and limited powers (they could not own stock). In the U.S. at the turn of the century, there were no financial institutions of sufficient size and geographical diversity to provide the bulk of needed capital directly to America’s new large enterprises.

For the large family-owned businesses that made up most of American industry at this time, founders (or their heirs) wanting to cash out thus had only two basic choices: (1) they could sell their stock into the securities market; or (2) they could merge with another firm, in which case the securities market would finance the merger. (Indeed, the primary role of the securities market at the turn of the century was not to raise new capital, but to finance the massive mergers at the end of the 19th century and to allow founders to cash out.)

2. Ibid., p. 373.
The dispersion of ownership that eventually resulted from such equity financing determined that professional, salaried managers (with perhaps modest stock holdings) would assume control of the day-to-day operations. Although descendants sometimes took over running the firm from the founders, that role tended to fall to hired managers. Then, over time, concentrated stock ownership dissipated into fragmented holdings as the heirs sold off the inheritance and the managers occasionally raised new capital in public markets.

The resulting combination of a large-scale enterprise, a professional (non-owner) management, and fragmented, diversified stockholders shifted control of public corporations from shareholders to managers. In contrast to business enterprises in Europe and elsewhere, dispersed shareholders and concentrated management became the distinguishing characteristics of the large American firm.

What Might Have Been? (Or the “Venture Capital” Model of Corporate Governance)

The separation of ownership and control proved functional and, in many cases, a major source of value in its own right. Good managers replaced often less motivated or sometimes incompetent heirs. Specialization of risk-bearing and management meant that good managers didn’t need to have their own source of capital to get to run large enterprises.

But separation via public stock markets was not the only plausible path. Some founders might have preferred that banks, insurers, or other financial institutions had instead become part owners of their businesses. Then the power of professional managers could have been balanced by financiers with large stakes and a continuing interest in the firm—much as happens in the small firms financed by U.S. venture capitalists.

Financiers like J.P. Morgan, it’s true, were able to play a major role in corporate governance at the turn of the century even without holding big blocks of stock, particularly when the client firms needed outside capital. Like modern-day venture capital and merchant bankers, Morgan and other influential investment bankers sat on corporate boards and participated in strategic decision-making. But this role proved to be short-lived, at least partly because political reprisals against the “money-trusts” in the early 20th century induced Morgan and other bankers to keep a low corporate governance profile.

Had national financing beyond the securities markets been available, a different pattern might have emerged. Larger financial institutions with nationwide scope may well have been able to finance more rapid expansion than that allowed by securities issuance or internally generated funds. Truly national financial institutions may also have been able to participate as substantial owners in the wave of end-of-the-century mergers and cash-outs. In that case, the institutions could have used their large blocks of stock to sit on the boards of the merged enterprises (much as venture capitalists and LBO firms like KKR do today) and so shared power with senior management. As I explain later, such a concentrated ownership and governance structure could have been one tool in the bundle to help control monitoring, information, and coordination problems that may well reduce the value of many U.S. companies today.

But, as things turned out, this “venture capital” model was not widely adopted for large firm governance in the U.S. Shareholders, it’s true, get to elect the board of directors, and the board appoints the CEO. But the actual flow of power, as everyone recognized, ran in reverse: The CEO recommended nominees to the board. Board members were typically either insider-employees or other CEOs with little reason to invest time and energy in second-guessing the incumbent CEO. The CEO’s recommendation for the board went out to the shareholders, whose small shareholdings gave them little incentive—or means—to find alternatives; they checked off the proxy card and returned it to the incumbents. In this fashion, the CEO dominated the election and the firm. And, although the balance of power may have shifted with the recent increase in shareholder and board-level activism, as recently as the 1980s many directors continued to “feel they are serving at the pleasure of the CEO-Chairman.”

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WHY U.S. BANKS WERE NOT READY FOR THE EXPANSION

When the large American corporation was emerging around the turn of the century, the dominant financial institutions—commercial banks and insurance companies—were in no shape to hold large blocks of stock. Industrial companies had learned how to operate nationally, but banks and insurers operated locally and could not own stock. When industries needed capital for expansion or to fund consolidations during the end-of-the-century merger wave, they could not go directly to a handful of commercial banks, much less to a single bank, that could provide all of the needed equity and debt from their own sources. National banks were national in name only, able to operate only from a single physical location.

When attempting to identify the origins of such restrictions on banking, most people think of the New Deal legislation of the 1930s—particularly, the Glass-Steagall Act, which separated commercial banks from investment banks. But the most serious restrictions on both banks and insurers came well before the New Deal. For banks, they were in place at the end of the 19th century; for insurance companies, they came shortly after the turn of the century. The New Deal was important in confirming the financial and ownership structures that already prevailed—and in confirming them during a period of flux when those structures could have been changed, but were not.

Restrictions on Branching

As two Federal Reserve economists put it, “For much of its history, the United States has had a banking system like no other in the industrialized world. Since the early 1800s, the U.S. banking system has been highly fragmented, consisting of numerous small banks without extensive branch systems.”6 States chartered their own banks, and Congress, influenced by local interests, refused to charter national banks that could operate more extensively than the politically powerful local banks.

Every few decades, the lack of diversification resulting from such geographic restrictions either caused or aggravated a U.S. banking “crisis.” This emboldened some political leaders to propose nationwide branching in order to strengthen the banking system. But, as happened when President Cleveland endorsed proposals to allow “national” banks to branch in 1895, the proposals were repeatedly blocked in Congress by well-organized unit bankers (bankers that operated from a single physical location). Indeed, the well-organized unit bankers not only stymied truly national branching for national banks, but induced Congress to reduce the capital requirement for rural national banks. The result was the establishment of many new banks, thus sowing the seeds for future bank crises and further strengthening the anti-branching banker constituency. Having more weak, local banks meant there were more players willing to invest in political action to block creation of national financial institutions.

Different political structures could have yielded different outcomes. Historically undemocratic Japan did not have the same open political structure that made American populism such a potent force. Japanese interest group configurations also differed from those in the U.S., and the national political structure was less responsive to local banking interests than the American structure. And, so, when the Japanese banking system faced a rash of failures in 1927, the Japanese authorities reacted by merging many banks into larger ones.

Such mergers were one of the major steps in the evolution of Japanese banks into the main banks that were at the center of the Japanese keiretsu after World War II. So, while American regulation was keeping banks small and local, Japanese regulation was making them much bigger. For better or worse, the Japanese banks had the financial strength to be able to take equity positions in most large firms after World War II. Large stock purchases of industrial firms by groups of four or five Japanese banks and insurers then produced the Japanese keiretsu, the networks of cross-ownership and influence among both industrial and financial firms that have dominated the Japanese economy since the 1950s.

Contrast Japanese policymakers’ decision to concentrate finance during its 1927 banking crisis

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With the outcome of the American banking crisis that took place soon after. Instead of encouraging bank mergers and allowing nationwide branching, U.S. legislators responded to the Depression-era bank crisis by enacting deposit insurance (which was intended to protect small banks from larger competitors) and separating commercial from investment banking (to prevent concentration of power among the larger banking operations).

What explains the American result? The answer has much to do with differences in politics. Most members of the U.S. Congress, given the strength of their ties to their local districts, had an interest in keeping banks small and local.7 Small-town American bankers were influential people; and, by exploiting the public sentiment against concentrated financial power, this interest group was consistently effective in Congress. And, so, Congress predictably chose to prop up the small banks with deposit insurance and other regulations designed to protect their ability to compete with larger banks at roughly the same time that an authoritarian Japan was concentrating its banking system.

**Product Restrictions**

Although geographic restrictions on U.S. banks were crucial, product restrictions also played an important role—and they too were in place well before the turn of the century. The National Bank Acts of 1863 and 1864 gave national banks only limited powers.8 Control of an industrial company was not even contemplated and, hence, out of the question. And, in 1892, when the controversy over whether national banks could own stocks got the attention of the Supreme Court, the ruling came down that the power to own stock was not listed in the Act, and so it was not granted.9

**Were Other Paths Possible?**

We have already provided glimpses of alternative ownership structures in the form of the Japanese keiretsu and U.S. venture capital practices. But another way to see what might have been is to look at early American financial arrangements. Two of these are worth examining in some detail: (1) the close connections between banks and industry in New England in the early 19th century (before banking restrictions became as important); and (2) the structure and history of the Second Bank of the United States.

Economic historians have shown that, in the first part of the 19th century, New England entrepreneurs bound their operating firms to the local banks. Yet these banks did not grow into national financial institutions, and the ties between the entrepreneurs and their local banks eventually withered. The primary reason these relationships failed to grow appears to be that, as economic opportunities shifted from New England to the national economy, the New England banks could not get good information about distant firms, and the bankers were able to participate in the national economy only as passive buyers of short-term commercial paper. As economic historian Naomi Lamoreaux put it, “[F]irms could issue their IOUs through note brokers, who would market them to banks and financial intermediaries across the country...[and] banks lost their ability to assess a customer’s total indebtedness.”10

Since evaluating the creditworthiness of companies is usually a banker’s strength, one wonders why the New England bankers ceded the profits to these note brokers. The most likely answer to this puzzle is that the bankers probably did not cede the profits voluntarily. Rather, because banks in regions with a capital surplus could not branch into capital-importing areas, the money could not move inside a single organization. But investment bankers could market notes and commercial paper throughout the country. Thus, entrepreneurs affiliated with banks could pursue economic opportunities to go national while their bankers, because of branching restrictions, could not. The commercial paper market—short-term IOUs from a debtor—was the way financiers and industrialists found to “contract around” the geographic restrictions on banks.

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The Fate of America’s First National Financial Institution

Ironically, one of the first American national business institutions was a bank, the Second Bank of the United States. Described by Alfred Chandler as the “first prototype of modern business enterprise in American commerce,” its organizational structure allowed it to coordinate complex financial transactions through its many branches to enable capital to move across the nation to support the flow of trade. But, as is well-known, Andrew Jackson killed this first national financial intermediary with his famous veto message refusing to re-charter the Bank.

The Second Bank had a double importance for the history of U.S. banking. It was not only a precursor of the modern-day central bank necessary for a strong banking industry, it was also a semi-private institution with an interstate branching network. Had it survived, its national branch network could have been a model for future private banking charters. The Second Bank, or more private but truly national banks, might have played a central financial role in the construction and merger of large national firms at the end of the 19th century.

Jackson’s veto of the renewal of the Second Bank’s charter can be attributed to both of the two key forces that would determine the future structure of U.S. financial institutions: interest group infighting and American populism. State banks felt threatened by the Second Bank, which competed with them and had some power to control them. This opposition was an early reflection of the local bank power that American federalism fostered and that tended to keep America’s financial institutions small.

Jackson’s refusal to renew the Bank’s charter also tapped the rich vein of populism in American politics. The veto message attacked the Bank as an elitist institution owned “by foreigners... and a few hundred of our own citizens, chiefly of the richest class.” The Bank had the potential to be run by a small group of people. “It is easy to conceive that great evils to our country and its institutions might flow from such a concentration of power in the hands of a few men irresponsible to the people...” Jackson’s forceful rhetoric helped imprint on the national psyche frightening images of an elitist concentration of private economic power. For decades following the veto, the message itself was assigned reading for schoolchildren.

Not until the 1990s were American laws changed to permit nationwide banks, at a time when banks were of diminishing importance in the economy.

HOW U.S. INSURERS LOST THEIR POWERS

Banks, though, were not the only powerful financial institution in the U.S at the turn of the century. In an era that preceded the rise of pension funds and mutual funds, life insurers were a central depositary for middle-class savings. Were they similarly affected by politics?

The early history of the life insurers suggests they were not. At the beginning of the 20th century, several of the largest American financial institutions were insurance companies, not banks. Although banks were confined to a single state, insurers were not. The largest New York insurers were twice as large as the largest banks and were moving into related financial activities. Some insurers were underwriting securities; some were buying bank stock and controlling large banks; and some were assembling securities portfolios with the potential for exercising control. Some insurance companies had already put as much as 12% of their assets into stock. Indeed, the three largest American insurers at the time—Equitable, Mutual, and New York Life—were growing so rapidly that they showed promise of developing into institutions that would rival the powerful German universal banks or the main banks in Japan. At the very least, they seemed ready to become much like the large modern British insurers, which hold considerable stock and play a more important governance role than their passive American counterparts.

But then politics intervened. In 1905, the insurance industry was rocked by scandal, revealing nepotism, insider financial chicanery, and bribery of legislatures. The New York legislature responded with a political inquiry, which came to be called the “Armstrong investigation” after the state legislator who chaired the committee. In 1906, new insurance

laws barred insurers from owning stock, controlling banks, or underwriting securities. For the next 50 years, insurers were banned from owning any stock at all—and serious deregulation of this ban on stock ownership by insurance companies did not begin until the 1980s.

In short, American politics limited the insurance industry to its core business of writing insurance and investing in debt. Today, although insurance companies have stock holdings that amount to about 5% of the total market (which puts them a distant third behind mutual funds' share of about 10% and pension funds' 30%), they play a negligible role in corporate governance.14

MODERN TIMES: MUTUAL FUNDS AND PENSION FUNDS

Mutual funds and pension funds, although long overshadowed by commercial banks and insurers, now account for the bulk of institutionally owned stock in the U.S., and their share of financial assets under management is expected to continue rising. Although the potential role of such funds in corporate governance has also been somewhat limited by legal and regulatory factors, political influences on laws and regulations that govern mutual funds and pension funds are less direct and clearcut than those that constrained the historical structure of American banking and insurance. But such laws and regulations do raise the costs of such funds becoming involved in corporate governance—and it's too early to say whether the funds will come to play a bigger governance role.

For example, mutual funds face portfolio limits that stop them from deploying much of their assets in big block positions with boardroom influence.15 And it is generally not worthwhile for funds with a small stake to attempt to play a big (which often means “expensive”) public role in governance. The few public exceptions seem to arise when a mutual fund, or a complex of funds, finds itself with a sizeable block. For example, when Kodak was in crisis and Fidelity found that its group of funds owned about 7% of the company, Fidelity became involved.

As for pension funds, although the laws governing such funds do not explicitly bar big blocks and boardroom activity, such activities are deterred by the reality that funds that deviate from prevailing practice expose themselves to greater business risks and the threat of litigation.16 Similarly, “little” mistakes with small ownership positions can be hidden and don’t usually lead to a lawsuit against the pension funds’ managers. But a misstep with a large block (even if embedded in a diversified portfolio) is more readily targeted for a lawsuit. Private pension funds are also typically under the control of the sponsor company’s managements, and most senior managers have usually not supported strong corporate governance activity. The public pension funds, by contrast, have been more active. For example, CalPERS and others have prodded boards to set up governance and review procedures.

Although the new institutional activism is about a decade old, it is still too early to say where it will all end up. Current arrangements could be the long-term, continuing result—that is, occasional institutional activism, usually following bad firm performance, but with few big blocks of stock and little continuing inside-the-boardroom role. On the other hand, the current moderate levels of activism could be an evolutionary step toward new roles such as acquiring industry and governance expertise, and even putting institutional representatives in the boardroom (thus moving along a path once cut off).17 But if this happens in a way that threatens corporate managers, one wonders whether the hostile takeover tensions of the 1980s will reemerge, and managers will once again call on state legislatures for protection.18

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14. Warren Buffett’s insurers are property and casualty companies, not life insurers; property and casualty insurers overall have a much smaller asset base than the life insurers have. Buffett’s authority to use even the property and casualty insurers for big blocks of stock required changes in the governing law, changes made in the 1980s.

15. To be sure, mutual funds’ positions rarely even come near these limits, but this could be the result of such limits in combination with other constraints that have prevented mutual funds from taking large blocks in the past.

16. And, because the historical structures and rules for banks and insurers have not looked kindly on governance activity, the pension law’s imitation rules favor the diversified, fragmented structures. See Mark Roe, “Mutual Funds in the Boardroom,” Journal of Applied Corporate Finance, Vol. 5, No. 4 (Winter 1993); Roe, Strong Managers, Weak Owners, ch 8 (mutual funds), ch 9 (pension funds).


18. Roe, Strong Managers, ch. 10 (takeover politics), and chs 16 and 21 (speculating on possible political influences today and in the future).
MODERN TIMES: SECURITIES LAW LIMITS ON SHAREHOLDERS’ JOINT ACTION

With historical regulation of the banks and insurers barring big equity blocks, and with mutual funds and pension funds too new or too constrained for all but a few to be capable of taking big blocks in big industrial firms, joint action by a number of large shareholders may be today’s most realistic corporate governance alternative to concentrated ownership for large U.S. firms. Given the institutionalization of stock ownership in the past couple of decades, ten or twenty owners of 1% of a firm could band together to involve themselves in corporate governance.

Obvious business reasons tend to frustrate this kind of coordination: some of the players don’t want to work with a competitor (if you identify a problem, sell fast rather than alert competitors with whom you’d work to fix it), the institutions are only rarely going to be able to contribute functionally, and so on. But on top of this, securities rules discouraged joint shareholder action by, for example, classifying informal meetings (and even telephone calls) among a handful of investors as proxy solicitations requiring public filings with the SEC. Such laws saw to it that financial players who wanted to be active but keep a low profile could not do both; they instead needed their lawyers every step of the way and had to “go public” to be active. If the ownership stake was small, the profitable action was usually to do nothing.19

Then, in the early 1990s, the SEC relaxed its view that made many informal communications among investors come under rules requiring proxy filings. That change increased the activity of some investors with sizeable (though far from control) blocks in working with other investors to bring about change. As one example, Michael Price’s recent actions in prodding Chase to merge with Chemical, taken largely through a mutual fund, were said to have been impossible before the SEC assured institutional investors that some forms of coordination would not be viewed as proxy solicitations.20

POTENTIAL COSTS: COULD OWNERSHIP STRUCTURE AFFECT PERFORMANCE?

It is hard to deny that American politics contributed historically to smaller and weaker banks and insurers than would otherwise have developed. And it’s quite possible that larger and stronger institutions would have taken bigger ownership stakes, such as those that are common in venture capital financing and in large firms in Japan and Germany. Big blockholding has costs in reducing diversification, and bigger institutions of course can hold bigger blocks at lower cost. But even if the form of corporate ownership was affected, long-term performance might not have been. Substitute tools accomplish at least part of what alternative ownership might do—and some of the substitute tools may well work better for some firms than ownership by a financial institution.

This brings us to the question posed at the beginning of this article: If the fragmented ownership of U.S. corporations was not economically inevitable, were the governance substitutes for concentrated ownership devised by U.S. firms and capital markets as efficient as the governance alternative that was foreclosed? To put the same another way, did the American adaptations demanded by U.S. law and politics end up imposing major costs on shareholders and the economy?

Although such costs are difficult to quantify, they can be divided into two major categories: (1) the costs of the original adaptation; and (2) the continuing costs of a less than optimal governance system.

First of all, even if the adaptations proved to be perfect substitutes, adaptation still cost something: new structures had to be built, experiments were tried and some failed, people who might have devoted themselves to another economic activity found themselves most profitably engaged in building these adaptive structures. As one example of such costs, some recent evidence indicates that at the time of one politically motivated restructuring—the Pujo investigation, which prompted Morgan and other investment bankers to leave the many boardrooms—the stock prices of Morgan’s client firms declined.21 While the reasons for the decline could have been several, one plausible interpretation is

20. Andrew E. Serwer, “Mr. Price is on the Line,” Fortune, Dec. 9, 1996, at 70 (Price takes bigger blocks through mutual funds when he can use proxy law rollback to coordinate with other owners to engineer changes at Chase.)
that the governance structure would be weakened, at least for a time. Adaptation, even if effective, usually isn’t costless; the stockholders at the time adaptations take place pay a price.

The harder question is whether there are continuing costs from America’s historical aversion to concentrated financial institutions with significant power in the boardroom. Given the many governance substitutes, it’s hard to see how these costs can be very great—unless the main substitutes have problems or are themselves subject to political constraints. But if the substitute tools are less effective for some firms in some situations, then such companies may bear ongoing governance costs—say, reacting a little too slowly to a shift in demand in some cases, or failing to ramp up a new profitable project as fast as possible.

Three kinds of cost could affect companies even today: monitoring costs, information costs, and industrial organization costs. Each has the potential to raise a company’s cost of capital and reduce its productivity. The next three sections spell them out.

**Monitoring Costs**

Monitoring costs are well-known and hardly need explanation. As suggested earlier, the separation of ownership from control could weaken managerial incentives and accountability. Directors representing institutions with large blocks of stock would presumably have the means, and their institutions the incentive, for more effective monitoring of managers.

When Monitoring is Likely to Be Important. Monitoring and corporate governance should matter least in highly competitive markets with little fixed, long-term capital and lots of growth opportunities. Managers who destroy value in such cases, or fail to increase it fast enough, will be unable to raise capital for growth and eventually be replaced. But when markets are concentrated, or the firms’ fixed investments are large and its growth opportunities few, managers will be somewhat free from competitive and capital market pressures. In that setting, managers who fail to use their capital efficiently need not face the consequences of error immediately; whether because oligopoly provides “slack,” or the firm has lots of long-lived capital in place, the firm can slowly waste away until one of the governance mechanisms kicks in to make managers do their job better (or replaces them).

Take the case of GM in the early 1990s. After almost a decade of shrinking market share and substandard stock-price performance, the company’s competitive problems culminated in 1991 with a loss of $7 billion from North American operations. At this late stage, pressures from institutional shareholders finally combined with competitive failure to force GM’s board to replace two senior management groups. If better internal governance mechanisms had been in place—ones that could have kicked in earlier—much of the loss in GM’s competition position and shareholder value might have been avoided.

As this example is meant to suggest, pressures for better governance can be seen as reinforcing the effects of competition in product markets. Good governance encourages a quicker response to competitive forces, bad governance slows the response. Because many companies have long-term, fixed capital, and some U.S. and global markets are still oligopolistic, governance reform can play an important monitoring role.

A Qualification. One obvious qualification needs to be made at this point: Because the institutional representatives would themselves be agents for others owning the stock, they would not be perfect monitors. Moreover, the blockholder itself, or the individuals managing the positions, could face conflicting incentives. For example, a commercial lender who is also a blockholder might overlook the poor shareholder returns of its borrowers while collecting fees and charging higher interest rates.

Thus, concentrated ownership by institutional is not a panacea, and some ownership forms could introduce their own monitoring costs. But the question is not whether changes in ownership structure would be costless (although public policy concerns must of course be considered when deciding to allow such changes). The question is whether block ownership and boardroom representation would reduce the overall agency costs faced by the corporation and its investors.

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Information Costs

When information about a company's strategy or prospects is complex or “soft” (i.e., difficult to quantify), management often finds it hard to communicate it to outsiders. Stockholders with small holdings—and the equity analysts who write research reports for them—may not have the incentives to spend much time trying to understand complex, technological information; so they might choose to ignore it and just look at the bottom line. And managers with good, but proprietary information would not want to reveal such information to the stock market because it could benefit their competitors. In either event, the stock market never gets the information; and, to the extent the market discounts share values for greater uncertainty (i.e., assumes the worst), information costs end up raising the firm’s cost of capital.

But such soft, complex, or proprietary information may be more readily conveyed to those who sit regularly in the boardroom. The ability to communicate the prospective value of a high-quality and cohesive middle management team, or the import of technical data generated inside the firm, may well be greatly improved by regular, private interaction between large stable stockholders and managers. In this sense, concentrated ownership may be able to lower the cost of capital by reducing information costs.

Another potentially important source of information costs are distortions of management’s incentives that could occur when managers are unable to communicate effectively with the market. If managers increase the long-run value of the firm in ways that investors cannot see right away, the managers may not get the “credit” right away (say, in the form of bonuses or payoffs from short-term stock options) their performance merits. Managers may then pass up profitable investments with long-term payoffs while blaming the “short termism” of the stock market. And both managers and markets will be behaving “rationally”—managers because they believe their superior performance will not be rewarded during their tenure, and investors because they lack both the information necessary to evaluate the profitability of such investments and the influence to bring about necessary changes if managers are wrong. Managers may even try to insulate themselves from the stock market (as many did during the hostile takeovers of the 1980s) by erecting anti-takeover defenses.

In theory, then, concentrated ownership structures can improve the flow of information from inside the firm to large shareholders, thus helping to deter the short-term propensities often seen in managerial behavior and sometimes in the stock market. Large holdings give the owner the scale economies needed to justify investing in the capability to acquire and process complex information. Big blockholders can afford to hire an engineering or marketing consultant that a small stockholder wouldn’t think of hiring. Finally, size and boardroom presence give large stockholders a strong incentive to protect proprietary information (because to behave otherwise would reduce the value of their own large stock positions).

Coordination Costs in Joint Long-term Investments

Multiple complex investments need coordination: An auto company builds an assembly line and needs a supplier to build a big facility to make the chassis or the transmissions or the engines. What stops one of them from extorting the other later on, after the other has built specific machinery that can’t be used for anything else? What stops the one who is stuck from finding their supply prices driven down to their variable costs, so that it can’t recover its original investment in the factory and machines?

This problem of coordinating joint long-term investments recurs in organizing industry, and can be especially costly when highly specific contracts cannot be written to govern the investments. The specific contracts can’t be written many times because business will change in ways the two parties can’t anticipate or because pricing formulas can’t be made before the business gets going.

One solution to this “contracting and coordination” problem is, of course, complete vertical integration: The customer—the assembly-line firm—buys up the supplier firms, or builds itself all of the necessary machinery, parts, and distribution systems. Although this “solves” the coordination and hold-up problems, it creates other problems, which can be more costly. Combining customers and their suppliers within a single firm tends to reduce managerial accountability for each and blunts incentives for efficiency.

A promising alternative lies in the multiple cross-holdings of stock by customers and suppliers,
especially when a half-dozen suppliers and customers must simultaneously make such commitments. A customer that partly owns, say, 5% of the stock of a supplier has less incentive to exploit the supplier than one who doesn’t. A customer that is a 5% stockholder and sits on a supplier’s board gets information with which to monitor management not just as a buyer of the supplier’s products, but also as a board member and stockholder. If the customer tried to take advantage of the supplier after the supplier has committed itself, a “keiretsu-like” coalition of shareholders could intervene to stop the opportunism.24

A third-party financier could cement these partial relationships, acting as an “escrow” agent that owns some of the equity of both the suppliers and the customers. Financial institutions big enough to hold, say, 5-10% of the stock of each of the suppliers and customers in a network could play this role. Although there’s evidence of this in Japan,25 one could also imagine a role for such arrangements in the U.S. Using such financing, for example, the bust-ups of the 1980s could have taken a somewhat different course. In the U.S. the choice has tended to be an “either/or” one, with possibilities lying only at the ends of the spectrum of independence versus integration. But, with third-party financing, some related companies might have been broken off from large vertical organizations, but networks of coordination could have been retained when it was important to do so. Under such arrangements, the financing institutions would broker deals when disputes between customers and suppliers came up, and smooth relationships during normal times.26

**THE CASE FOR COMPETING GOVERNANCE SYSTEMS**

Today, each nation tends to have its own semi-proprietary governance system, in which the largest public companies have relatively homogeneous ownership structures. In Japan, main banks both lend to and own 5% of the stock of large firms, with other banks also taking 5% blocks as well. In Germany, a handful of banks and insurers have many large blocks of stock, some owned directly, some built from custodial holdings for individual investors. Thus, whereas most large U.S. companies have fragmented ownership structures, most large Japanese firms and many European firms have large-block shareholders. There is little diversity within national economies.

One major advantage of the U.S. financial system is its flexibility. When large organizational structures become inefficient in the U.S., entrepreneurs set up new firms that compete with old firms—and, through the securities markets, small competitors can often quickly raise the financing they need to be viable. And, by competing with the large organizations, small firms either end up improving the large firms, or replacing them. American-style hostile takeovers, though much reduced since the 1980s, also help bring about such changes. The U.S. system also seems to excel at big-leap improvements, because whole new structures (MCI is a good example) can be quickly built by American entrepreneurs using venture capital financing and a vibrant securities market.

By contrast, in centralized financial systems like those of Japan and Germany, the central players seem less willing to finance new ventures, either because they fail to see the advantages of the innovation or because the new ventures would compete with their own large corporate clients. On the other hand, foreign bank-centered systems may be able to make stronger commitments to established firms that help enable those companies to make steady improvements in known technologies. To the extent they are successful in reducing the information and monitoring costs faced by outside investors, bank-dominated systems may enable such companies to carry out their investment plans during difficult periods.

But, for purposes of public policy, where does this comparison leave us? The recognition that the U.S. securities markets have greater flexibility, but less ability to make long-term commitments, than bank-centered economies like Japan and German might seem to fail to yield any clear policy recommendations. It would be a mistake to list the advantages and disadvantages of all the different systems, weigh them, and then pronounce one the winner. It would

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26. To be sure here, cross-ownership is not without its own costs in creating conflicts of interest—a supplier may ignore bad management if it gets a better price. Industrial companies are not set up for stock ownership and are taxed unfavorably on their stock returns.
also be a mistake to decide that if there is no clear winner—or even if the securities markets were the winner—we ought then to preserve all aspects of the current American system.27

Such arguments are flawed because they exclude an important middle ground: the possibility of encouraging competition among organizational forms in the same national economy. Competition between the two forms should bring out the best of both. Indeed, a national economy with competing forms of governance should, all else equal, eventually outperform an economy dominated by a single form. A mixed system could enable its firms to make more rapid and productive responses to changes in their markets and technologies.

Here’s the basic idea: Begin by imagining that the ownership structure of the firms in two industries, A and B, are evenly divided between American-style fragmented ownership and Japanese-German concentrated ownership. Industry A is a high-tech, high-growth industry with lots of investment opportunities and large requirements for new capital. By contrast, Industry B is a low-tech, slow-growth industry with few investment requirements and excess capital.

High Growth, Shortage of Capital. Assume that in Industry A the value of a certain technology becomes apparent to inside managers, but the payoff from such investment is not the kind that can be communicated effectively to scattered outside stockholders. In that case, the managers of the 50% of the firms in that industry with fragmented ownership choose not to invest because they expect to be penalized in the short-run (with smaller salary increases or reductions in the value of their stock options). At the same time, the managers of the other half of Industry A’s firms can talk privately to their large-block stockholders, who are able to understand the needed change. In these circumstances, the firms with concentrated ownership get a competitive advantage by reacting faster. Eventually, however, product market competition brings even the slower-moving, diffusely owned firms into line, as they react with a lag.

And here’s the benefit of competing governance systems: If none of the firms in the industry had large blockholders, managers of all companies might be more reluctant to make the investment because of their fear that the stock market would punish them until the supporting information was diffused throughout the economy.

Low Growth, Excess Capital. Now let’s turn to Industry B, with limited growth opportunities and heavy fixed capital. In this case, it is likely to be those companies with concentrated ownership that respond most slowly. The insiders—a group that includes the managers and the big blockholders—may be reluctant to acknowledge that downsizing outmoded facilities is necessary because demand isn’t going to come back to the industry. In this scenario, companies with dispersed ownership sometimes may act first. After the stock price is driven down, either insiders are forced to reform from within, or outsiders launch a hostile takeover and oust the incumbents. And then, once this information gets pounded into the industry in the form of higher stock prices for the downsized firms, then the big blockholders might help to speed change in their own firms.

As these two examples are intended to suggest, competition among different governance forms can speed change and adaptation. Product market competition, to be sure, will eventually bring about necessary change if all else fails. But even the increasingly global character of product market competition is no guarantor that the needed changes will be the quickest and most productive possible. Better governance can speed along needed change.

One might mistakenly imagine that global competition is enough to bring about change and that governance is therefore irrelevant. But this isn’t true; a nation can insulate its firms from competitive forces. It must pay a price in lower living standards, but that doesn’t mean that insulation can’t be bought.

Imagine a nation that resists building a modern governance system and perpetuates some state ownership of enterprises, entrenches old managerial elites in the private businesses, or keeps outmoded labor arrangements. Let’s assume further that such entrenchment leads to substandard management in the majority of that nation’s firms. Must this governance system collapse under the threat of heightened international competition? Is it unstable?

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27 Nor is it correct to “measure” how much politics shaped the institutions of governance and pronounce as the winner the nation that had the “least” political influence. That is, in France, Germany, and Japan, politics probably had more impact on the structure of the corporation and the institutions that own them than it had in the U.S. In Germany, securities markets were stifled, mandatory co-determination was added, and a rigid corporate law was kept in place. Therefore, one might (mistakenly) reject the idea that politics influenced the form and possibly the costs of organizing the large American firm.
A national economy with competing forms of governance should, all else equal, eventually outperform an economy dominated by a single form. Such a mixed system could enable its firms to make more rapid and productive responses to changes in their markets and technologies.

The answer is “no” to both; it need not collapse and it could be stable. While global competition pressures that country’s firms to improve, it doesn’t require that they change. What counts is whether the firms produce competitive products that can be sold. The firm can continue to compete with an outmoded governance structure if it “saves” somewhere else with an offsetting advantage. It can save somewhere else by paying its employees (or some other immobile input) less. This result, while reducing that nation’s standard of living relative to others’, does not necessarily lead to economic instability. Stability depends as much on a nation’s politics as it does on global competition.

CONCLUSION

America’s fragmented ownership, a shift in power to professional managers, and the suppression of large owners did not threaten the widely held American corporation as an organizational form because the U.S. firm and its investors adapted. Even if the structure had some weaknesses, its weaknesses were outweighed by its strengths. While the separation of ownership from control reduced managerial accountability and incentives, and made the communication of strategic information more difficult, dispersed ownership facilitated economies of scale and the substitution of professionalized management for the often less capable heirs of the founders.

Competition often makes companies efficient regardless of their governance structure. Competition in product markets—and in managerial labor and capital markets as well—helped to align the interests of shareholders and managers, because the firm must get out a competitive product to survive in the long run. In the 1930s, 1940s and 1950s, America was the world’s only continent-wide open market, which meant that nowhere else in the world could several firms in an industry reach economies of scale and have workable competition and political stability. Markets abroad were closed, other nations were too small, transportation and communication costs were too high, and political upheaval was common.

But, besides the stimulus provided by competition, the large U.S. public firm also prevailed primarily because of its (and its investors’) ability to strengthen managerial accountability and incentives. Through both internal and external adaptations, the public corporation succeeded in balancing the problems of managerial control with the demand for outside capital and diffusion of risk. Internally, the firm controlled managerial agency problems with outside directors, with a managerial headquarters staff responsible for overseeing the operating divisions, and with the use of managerial incentive compensation. Externally, hostile takeovers, proxy contests, and the threat of both further disciplined managers. A remaining question, however, is whether another tool in the governance toolbox—more concentrated ownership—would have helped some firms to adapt more quickly or with fewer costs.

Today, stock is moving from individuals to institutions. This trend toward greater institutional ownership and voice is critically important, and we can interpret it in two ways. Seen through the sweep of 100 years of American financial history, it can be viewed as yet one more adaptation to political constraints on U.S. financial institutions. But it can also be understood as the long-delayed break-out of more concentrated ownership and shareholder voice after previous institutional alternatives—concentrated ownership by banks and insurers—were suppressed.

That a dispersed ownership system may have costs does not, of course, mean that we should force firms to have more concentrated ownership structures—or that we should “subsidize” big blocks, or "tax" fragmented holders who trade vigorously. But we should also resist the temptation to add up the costs and benefits of each national governance system, pronounce one the winner, and then use law to move a system to the preferred governance model. Even if securities markets are better overall than concentrated ownership, concentrated ownership might be better for enough firms now and then that allowing such ownership structures could encourage better overall corporate performance in the future. There are enough tantalizing possibilities that we should permit outcomes that have been discouraged by laws and regulation. In America, that would mean loosening restrictions such as some of the current residual portfolio rules and securities law hindrances.

No corporate governance silver bullet will cure whatever governance ills occasionally afflict some American firms. Since a casual look at the concentrated governance systems in Germany and Japan shows lots of governance failures, one should be skeptical of any claim that concentrated ownership is superior and thus should be adopted by most companies. Institutional strength has obvious defects. It creates severe conflicts of interest, particu-
larly if the institution sells something—a product, debt, or financial services—to the firm in which it owns stock. Such relationships could deteriorate into mutual managerial self-protection and, in so doing, discourage entrepreneurial initiative and leadership. And increased institutional power could lead to political pressure for more government intervention, which has tended not to work well in the U.S., and may yet prove to work poorly abroad. These imponderables are so large that any policy conclusion must be tentative, keeping in mind that where there are expected benefits there are likely to be some costs, too.

At the same time, one should not collect the stories of foreign failures at Metallgesellschaft, Daimler-Benz and others, and then unequivocally endorse American-style corporate governance (with its own failures, such as ADM and the decade-long delay before GM seriously addressed its problems). Rather one should recognize that each system has strengths and weaknesses. Because America is big and capable of absorbing multiple governance systems, the U.S. has a greater potential than other nations of facilitating both organizational forms (and their hybrids), and allowing them both to compete.

So, my policy prescription is simple: since no governance form seems obviously superior for all firms at all times, we ought to allow competition among governance systems. Vestigial rules that serve little public purpose but hinder the emergence of competing governance structures should be revised. In most nations where the evidence is available, politics has favored some forms of organization and ownership over others. In Germany, bank influence has been favored, stock markets suppressed. In Japan, regulation blocked the growth of public capital markets and channeled post-war financing through banks. America, as we have seen, has not been immune to these political influences, which have favored liquid public markets and small-town bankers at the expense of concentrated finance. In suppressing alternatives to the diffusely held public corporation, American law and political history have suppressed competition among ownership forms.

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