

**RISK IN REGULATION: A US PUBLIC FIRM  
OWNERSHIP PERSPECTIVE**

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a dissertation submitted to the Faculty of Graduate Studies of York University in partial fulfillment of the requirements for the degree of

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by AVIV PICHHADZE

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## ABSTRACT

The study examines different approaches to the regulation of the capital markets with a focus on explaining why certain assumptions about markets, actors, and systems came to be embedded in the regulatory practice in the American capital markets. More specifically, I examine regulatory assumptions about the nature of public firm ownership, the distortions that these assumptions introduced into the regulatory framework governing the securities markets, and the epistemological and risk-based implications of these distortions to actors, markets, and the regulatory system. The analysis draws on a number of theoretical approaches and methodologies including legal history, law and economics, comparative law, complexity/systems analysis, socio-legal analysis, and political economy.

This study analyzes the performance of the US Securities and Exchange Commission as the principal regulator of the American capital markets. The regulatory framework arguably reflects the Commission's perceptions (of market realities) and preferences (in response to these "market realities"). The federal proxy rules found in s. 14(a) of the Securities Exchange Act of 1934, used as a case study in this volume, exemplify this claim. As one of the original responsibilities assigned to the Commission by Congress, s. 14(a) of the 1934 Act gave the agency near-complete authority to regulate the federal proxy process. Thus, the functioning of the federal proxy regime hints at the Commission's performance as a regulator. Since s. 14(a) deals with proxy solicitation of shareholder votes, one essential policy consideration is the nature of corporate ownership. To evaluate the Commission's knowledge in relation to ownership, we need to appreciate how the agency evaluated underlying assumptions vis-à-vis ownership;



displayed awareness of changing socio-economic realities in the securities markets; and developed responsive regulatory measures accordingly.

The analysis highlights how the Commission missed learning opportunities (to varying degrees) over the years vis-à-vis (i) distortions introduced into the regulatory framework in the 1930s, (ii) implications of these distortions to the stability of the regulatory framework, (iii) demographic changes in the nature of public firm ownership leading to the formation of an ownership structure not previously discussed in the literature, which I call the “market oriented blockholder model,” (iv) new forms of endogenous risks relating to the regulatory framework, which I call “regulatory systemic risk.” The cumulative impact of these factors have negative implications to the agency’s reputation and legitimacy.

These findings suggest that the Commission needs to optimize its process to become what I call a “learning regulator”—an organization displaying adaptability to the evolving environment subject to its oversight through the acquisition, generation, and translation of knowledge and the modification of its behavior to reflect new knowledge and insights. To facilitate such optimization, I develop an organizational learning model tailored to administrative agencies—the “learning regulator framework.” Measures adopted pursuant to the model encourage organizational learning, risk reduction, and enhanced efficiency in the regulated environment. These measures, in turn, enhance the regulator’s reputation and shield its legitimacy from criticism.

## ACKNOWLEDGEMENTS

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# CHAPTER 1, INTRODUCTION

## I. OVERVIEW

The Securities and Exchange Commission (SEC) in the US was created in 1934 as part of the New Deal measures adopted by the US government after the Great Depression of 1929.<sup>1</sup> The mission of the SEC is (i) to protect investors, (ii) maintain fair, orderly, and efficient markets, and (iii) facilitate capital formation.<sup>2</sup> The study examines the performance of the SEC in its ability to meet two of its stated purposes: (1) maintaining efficient markets and (2) protecting investors. To do this, the study adopts a unique approach to the evaluation of the performance of policymaking in the area of securities law by focusing on legislative efforts in the area at two significant points in time – the 1930s and 2010 – with the common thread between the two periods being public firm ownership.

Modern securities legislation in the US was first introduced in the 1930s, in the form of the Securities Act of 1933 and the Securities Exchange Act of 1934, in the aftermath of the Great Depression of 1929 for the purpose of restoring the public's confidence in the American capital markets and for the promotion of investor protection.<sup>3</sup> Nearly eighty years later, as a result of the

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<sup>1</sup> Anne M. Khademian, *The SEC and Capital Market Regulation: The Politics of Expertise* (Pittsburgh: University of Pittsburgh Press, 1992); James McCauley Landis, *The Administrative Process*, Storrs lectures on jurisprudence, Yale School of law 1938 (New Haven, Yale University Press, 1938); SEC, "The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation," U.S. Securities and Exchange Commission <http://www.sec.gov/about/whatwedo.shtml>.

<sup>2</sup> ———, "The Investor's Advocate".

<sup>3</sup> Ibid.

2008 economic crisis, policymakers in the US were facing challenges posed by the greatest economic shock to the US financial system since 1929. Consequently, in 2010, policymakers introduced the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which has been hailed as the greatest regulatory change to US financial markets since the 1930s, for the purpose of, among other things, increasing investor protection.<sup>4</sup>

The common thread of ownership between the 1930s and 2010 is found in the connection between the proxy rules found in s. 14(a) of the Securities Exchange Act of 1934 and s. 971 of the Dodd-Frank Act, dealing with proxy access. Section 971 was introduced as rule 14a-11 by the SEC in August 2010 with the intention of enabling shareholders to nominate directors to the firm's board on the company's proxy materials. Interested observers, however, know that the connection between the two time periods extends beyond the concept of ownership. The two periods also share the policy rationale for the legislative efforts. This policy rationale, or fundamental assumption, is that the US capital markets are characterized by a fragmented ownership structure, where dispersed shareholders require government intervention for the purposes of protecting them from abuses by management. The perseverance of this policy assumption for nearly eighty years, however, raises a question regarding its relevance in light of evolutionary changes that occurred in the US markets during this time frame.

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<sup>4</sup> IBA's Task Force on the Financial Crisis, "A Survey of Current Regulatory Trends - Report of the IBA Task Force on the Financial Crisis," (The International Bar Association, 2010).

## II. SEC – THE REGULATOR

The SEC was established in 1934 pursuant to the Securities Exchange Act of 1934 (the “1934 Act”) to administer the federal securities laws found in the Securities Act of 1933 (the “1933 Act”) and the 1934 Act. The 1933 Act largely sought to provide investors with adequate information during public offerings.<sup>5</sup> But, the Act “represented at best a partial solution. Shareholders received complete information only during a public offering. Investors in the secondary market had no similar protections, an omission sharply criticized.”<sup>6</sup> To correct this omission, the 1934 Act mandated public firms with filing of annual and periodic reports with the SEC that were made available to anyone interested.<sup>7</sup> These disclosure requirements were intended to protect both present and future investors.

The SEC performs its role in one of two ways: (i) direct regulation (through rules, orders, and enforcement) and (ii) supervision and oversight of industry self-regulatory bodies (such as the New York Stock Exchange and the National Association of Securities Dealers).<sup>8</sup> The agency's rule-making power originates from sections of the 1933 and 1934 Acts granting authority to the SEC to promulgate rules that have the force of law. Such rules, which are introduced by direct legislative delegation, are valid and have the force of law as long as their carried out in accordance to statute.<sup>9</sup>

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<sup>5</sup> Robert J. Brown, "The Regulation of Corporate Disclosure. § 2.01 Historical Overview," (Westlaw, 2010), 2-4.

<sup>6</sup> Ibid., 2-5.

<sup>7</sup> Ibid., 2-5 - 2-6.

<sup>8</sup> Thomas Lee Hazan, "I.B. The Securities and Exchange Commission," in *Federal Securities Law (2d ed.)* (2003).

<sup>9</sup> Ibid. The need to delegate legislative power to administrative agencies has long been recognized by American courts. For example the US Supreme Court in *Sunshine Anthracite Coal Co. v. Adkins* (310 U.S. 281, 298 (1940))

The SEC was one of four new regulatory bodies established as part of the New Deal measures adopted by Franklin D. Roosevelt's government based on the lessons learned as a consequence of the Great Depression of 1929 in the US.<sup>10</sup> The New Deal "had been sold to the public in 1932 and 1934 as a means of achieving security and stability,"<sup>11</sup> The New Deal measures reflected FDR's belief "that government not only could, but should, achieve the subordination of private interests to collective interests, substitute co-operation for the mad scramble of selfish individualism."<sup>12</sup> This philosophy was "the heritage of a series of economic and social crises that began in 1873, the bywords of a progressivism that for over sixty years had preached the need for controlling the increasing concentration of economic power and the need for converting that power to social ends."<sup>13</sup>

The solution to the increasing concentration of economic power in the American economy in the pre-New Deal era was to be found in a menu of solutions comprising principally of two choices offered to FDR. The first solution was offered by what came to be known as the Brain Trust (a team of advisors consisting of Adolf Berle, Rexford Tugwell, and Raymond Moley), who rejected the Brandeis-Wilson progressive approach to reform. The second solution

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noted, "[d]elegation by Congress has long been recognized as necessary in order that the exertion of legislative power does not become a futility." More recently, in *Mistretta v. United States* (488 U.S. 361, 372 (1989)) the US Supreme Court noted, "in our increasingly complex society, replete with ever changing and more technical problems, Congress simply cannot do its job absent an ability to delegate power under broad general directives."

<sup>10</sup> David M. Kennedy, *Freedom from Fear: The American People in Depression and War, 1929-1945*, The Oxford History of the United States (New York: Oxford University Press, 1999). 367.

<sup>11</sup> Raymond Moley, *After Seven Years* (New York, London,: Harper & Brothers, 1939). 310.

<sup>12</sup> *Ibid.*, 14.

<sup>13</sup> *Ibid.*

was offered by Felix Frankfurter (who recommended James Landis and Benjamin Cohen for the drafting of the 1933 Act and Cohen and Tom Corcoran who drafted the 1934 Act), who believed in the progressive reform agenda advocated by the Brandeis-Wilson school.

Members of the Brain Trust believed that “the heart of our difficulty was the anarchy of concentrated economic power ...<sup>14</sup> but the solution was to be found in the forerunner of Tugwell’s *Industrial Discipline and the Governmental Arts*<sup>15</sup> and Berle and Means’ *The Modern Corporation and Private Property*<sup>16</sup> – *Concentration and Control*<sup>17</sup>, published in 1912 by Charles Richard Van Hise.”<sup>18</sup> The historian David Kennedy pointed out that the thread that bound Van Hise, Berle, and Tugwell’s approach was “that concentration of economic power in huge industrial enterprises was a natural and beneficial feature of modern advanced societies, and that these economic concentrations of private power necessitated the creation of ... governmental regulatory bodies.”<sup>19</sup> Berle and Tugwell, who formed part of the Brain Trust, took this thesis “a step further, when they argued that it was government’s right and responsibility not

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<sup>14</sup> Ibid.

<sup>15</sup> Rexford G. Tugwell, *The Industrial Discipline and the Governmental Arts* (New York,: Columbia University Press, 1933).

<sup>16</sup> Adolf Augustus Berle and Gardiner Coit Means, *The Modern Corporation and Private Property* (New York,: The Macmillan company, 1933).

<sup>17</sup> Charles Richard Van Hise, *Concentration and Control; A Solution of the Trust Problem in the United States* (New York,: Macmillan, 1912).

<sup>18</sup> Moley, *After Seven Years*: 24.

<sup>19</sup> Kennedy, *Freedom from Fear*: 120-21.

merely to regulate discrete economic sectors but to orchestrate the economy's various parts according to an overall plan."<sup>20</sup>

Frankfurter, Landis, Cohen, and Corcoran's approach to securities regulation was rooted in progressive ideology. As Moley pointed out, "the idea of having a securities act, in the first place, was an expression of the Wilson-Brandeis regulatory philosophy."<sup>21</sup> Much to the disappointment of the members of the Brain Trust who helped shape many of FDR's policies, FDR would opt for the Brandeis-Wilson progressive ideology in building the regulatory framework governing the American securities markets.<sup>22</sup> This ideology stood against bigness – both in the markets and in government.<sup>23</sup> That is, while it preached for government intervention in commercial affairs, it also sought to curb the government's intervention in those affairs so that it does not stifle commerce.

The agency, it is argued, represented a response to demands for expertise in government.<sup>24</sup> The SEC, it was argued, "on the basis of its expertise, and not Congress, on the basis of its electoral connection, is charged with determining the policy that best serves the

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<sup>20</sup> Ibid., 121.

<sup>21</sup> Moley, *After Seven Years*: 179.

<sup>22</sup> Ellis Wayne Hawley, *The New Deal and the Problem of Monopoly: A Study in Economic Ambivalence* (Princeton, N.J.: Princeton University Press, 1966). 306-11; Rexford G. Tugwell, "The Progressive Orthodoxy of Franklin D. Roosevelt," *Ethics* 64, no. 1 (1953): 17.

<sup>23</sup> A. C. Pritchard and Robert B. Thompson, "Securities Law and the New Deal Justices," *Virginia Law Review* 95, no. 4 (2009).

<sup>24</sup> Khademian, *The SEC*: 23; Landis, *Administrative Process*.



public interest.”<sup>25</sup> That is, the securities regulatory framework in the US is “as much a product of the preferences of SEC personnel and decisions made by the agency as of preferences and priorities of the agency’s legislative committee.”<sup>26</sup> As such, the SEC and its personnel have “a politically independent and significant role to play in formulating securities policy.”<sup>27</sup> Phrased differently, it is arguable that the regulatory framework governing the securities markets in the US is a reflection of cognitive constructs (of the market realities) and preferences (in response to these “market realities”) of the regulator.

The deference accorded to the SEC by the legislator by virtue of the agency’s expertise in the securities area has at least one implication: the SEC is required to maintain, not only the enforcement of the rules, but also the rules themselves. That is, the agency is required to adapt to the rules when necessary. In this context, adaptation refers to awareness by the agency to trends in the environment subject to its oversight, where “awareness” is evidenced by appropriate amendments to legislation to reflect the dynamic realities of this environment. This, according to Landis, is the advantage of the expert regulator over government:

With the rise of regulation, the need for expertise became dominant; for the art of regulating an industry requires knowledge of the details of its operation, ability to shift requirements as the condition of the industry may dictate, the pursuit of energetic measures upon the

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<sup>25</sup> Ronald J. Pestritto, "The Progressive Origins of the Administrative State: Wilson, Goodnow, and Landis," *Social Philosophy and Policy* 24, no. 01 (2007): 22.

<sup>26</sup> Khademian, *The SEC*: 20.

<sup>27</sup> *Ibid.*, 207.

appearances of an emergency, and the power through enforcement to realize conclusions as to policy.<sup>28</sup>

To examine whether the SEC displays adaptation, this study looks at the treatment of the concept of ownership in the context of the proxy rules found in s. 14(a) of the Securities Exchange Act of 1934.

### III. PUBLIC CORPORATE OWNERSHIP – REGULATORY PERSPECTIVE

Public firm ownership affects a number of areas in the regulatory framework governing the securities markets. For example, the concepts of ownership and ownership structures affect such matters as (i) takeovers and defensive measures adopted by firms to thwart such activity, (ii) conflict of interest rules and related party transactions, (iii) significant corporate action and disclosure rules, (iv) voting procedures, the allocation of power between directors and shareholders and the distribution of power between shareholders.<sup>29</sup> As such, regulatory understanding of ownership and ownership structures affects the stability of the entire regulatory framework governing the securities markets.

Ownership structures in any given economy also “affect the nature of problems that outside investors face and, in turn, the measures that could be most effective in addressing these problems.”<sup>30</sup> That is, legislation, where the concept ownership is employed, should be informed

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<sup>28</sup> Landis, *Administrative Process*: 23-24.

<sup>29</sup> Lucian A. Bebchuk and Assaf Hamdani, "The Elusive Quest for Global Governance Standards," *University of Pennsylvania Law Review* 157, no. 5 (2009); Reinier H. Kraakman, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford; New York: Oxford University Press, 2004).

<sup>30</sup> Bebchuk and Hamdani, "Elusive Quest," 1280.

by the realities in the markets subject to the regulation in order to appropriately address the concerns in the particular economy. Bebchuk and Hamdani provided several examples to illustrate this point in the context of economies characterized by concentrated ownership and economies characterized by diffused or fragmented ownership.

One example provided by Bebchuk and Hamdani relates to the nature of the agency problem or the relations between agents and principals.<sup>31</sup> This problem arises when outside investors provide capital to a public firm. Here there is a risk that an insider (or the agent) will influence the firm's decisions in an opportunistic manner to advance their own private interests at the expense of the outside investors (the principal). The difference between economies characterized by concentrated ownership and economies characterized by fragmented ownership is the identity of the insider or the agent.

#### **A. SHAREHOLDER-MANAGER TENSION**

In the case of fragmented ownership, Bebchuk and Hamdani pointed out that shareholders (the principal) are unable to effectively monitor corporate managers (the agent) and, as such, shareholders are exposed to the risk that managers' interests in running the company may not be identical to those of the shareholders. Thus, the fundamental concern to be addressed by regulation is the opportunistic behavior of managers at the expense of shareholders or the shareholder-manager tension.

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<sup>31</sup> Ibid., 1281. Other areas considered by Bebchuk and Hamdani where ownership structures affect (and inform) regulation are contestability of control, ability of shareholders to exercise power, and ways that opportunism benefits insiders.

## **B. SHAREHOLDER-CONTROLLING SHAREHOLDER TENSION**

In the case of concentrated ownership, Bebchuk and Hamdani provided that controlling shareholders have the means and the incentive to monitor performance of corporate managers. As such, the risk that corporate managers will act in a manner that diverges from shareholder interests is minimized. However, controlling shareholders may have interests that are not in common with other shareholders and may use their power to advance such interests. Thus, the fundamental concern, according to the authors, to be addressed by legislation is the opportunistic behavior of controlling shareholders (the agent) at the expense of other shareholders (the principal) or the minority shareholder-controlling shareholder tension.

## **C. REGULATORY KNOWLEDGE**

The onus placed on the regulator is to observe and inform itself of the particular ownership structure that the markets subject to its supervision exhibit, and fashion a regulatory structure that addresses the ownership peculiarities displayed by these markets. That is, the regulator's knowledge of the markets should be reflected in the regulatory framework. To the extent that regulatory knowledge (i.e., the organizational knowledge of the regulator that informs the regulator for the purposes of executing its duties) is deficient, a hazard is introduced. The hazard emerges from the misalignment between regulatory views of the markets (when engaging in the policy-making process) and market realities.

## **D. THE LEARNING ORGANIZATION**

The prospect of deficiencies in the regulator's organizational knowledge ushers the consideration of whether (to the extent that regulatory knowledge is deficient) the regulator is a learning organization. According to Garvin, "a learning organization is an organization skilled at creating,

acquiring, and transferring knowledge, and at modifying its behavior to reflect new knowledge and insights.”<sup>32</sup> According to Argyris, “[o]rganizational learning is a process of detecting and correcting errors. Error is for our purposes any feature of knowledge or knowing that inhibits learning.”<sup>33</sup> Argyris also noted that organizational norms may inhibit learning.<sup>34</sup> These views, which are couched in the language of organizational theory, are not too dissimilar in essence from the language used by Landis in describing the administrative agency as an agile entity able to modify its policies and behavior based on emerging needs and demands posed by the regulated environment in the passage quoted above.

In the context of ownership and regulation, learning means that the regulator should, could, and must monitor its regulated environment for any changes in the ownership structures exhibited by the firms in the markets subject to the regulator’s oversight for the purposes of updating its organizational knowledge and, in cases where changes have in fact occurred, translate such new knowledge into meaningful amendments to both its own organizational knowledge and the appropriate areas of the regulatory framework. In the event that regulatory knowledge is deficient, either as a consequence of failing to observe or of failing to act appropriately based on changes in ownership structures within a given economy, a hazard is introduced into the regulatory framework. One strategy to address such a hazard is through the examination of organizational knowledge and norms.

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<sup>32</sup> David A. Garvin, "Building a Learning Organization," *Harvard Business Review* 71, no. 4 (1993): 80.

<sup>33</sup> Chris Argyris, "Double Loop Learning in Organizations," *Harvard Business Review* 55, no. 5 (1977): 116.

<sup>34</sup> *Ibid.*

## **E. THE OWNERSHIP ASSUMPTION IN THE 1933 AND 1934 ACTS AND OF THE SEC**

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 are said to have been influenced by the 1932 study by Berle and Means,<sup>35</sup> which described the divorce of ownership and control in large public corporations and the extent of ownership fragmentation in those firms.<sup>36</sup> As such the drafters of the securities acts introduced an imbalance into the regulatory framework governing the capital markets. This reflection becomes clear when we consider several observations.

Both the 1933 Act and the 1934 Act were the product of the followers of the progressive liberal school of Louis Brandeis, who were, as noted earlier, at odds with members of the Brain Trust (of which Berle was one) vis-à-vis the policy framework that should be adopted in addressing the ills of the 1929 market crash. Both schools of thought, however, were variants of the liberal school that viewed with suspicion the giant corporations and the people who managed them. *The Modern Corporation and Private Property* provided both schools with the empirical proof needed for regulatory intervention and framework. The spirit of the day within policy circles advising FDR was that ownership is separated from control in large public firms and that this needed an address by the government.<sup>37</sup>

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<sup>35</sup> Berle and Means, *Modern Corporation*.

<sup>36</sup> See, e.g., William W. Bratton, "Berle and Means Reconsidered at the Century's Turn," *Journal of Corporation Law* 26, no. 3 (2001); Robert Hessen, "The Modern Corporation and Private Property: A Reappraisal," *Journal of Law and Economics* 26, no. 2 (1983).

<sup>37</sup> William W. Bratton and Michael L. Wachter, "Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation," *Journal of Corporation Law* 34, no. 1 (2008).

Accepting the results of Berle and Means<sup>38</sup> meant two things. Fragmented owners who did not command any influence over management needed government protection. In these firms the tension to be resolved by regulation was that between shareholders and managers (or the shareholder-manager tension). Accepting the findings of Berle and Means, however, also, invariably, meant receipt of the biases in their study. In particular, their bias against small- and medium-sized firms as being unimportant.

Though small- and medium-sized firms accounted for approximately 77% of the firms in the Berle and Means study, these firms were deemed by the authors to be unimportant given that they did not command any market dominance. These “unimportant” firms did not exhibit a complete separation from control and the ownership structure in these firms was characterized by a blockholder ownership structure. As such, in this class of public companies, management was less likely to abuse shareholders. Yet, in this class of companies there was another tension that should have been addressed via regulation – the minority shareholder-blockholder tension (or the potential of abuses of minority shareholders by blockholders who may act in their own self-interest). This tension, however, was not adequately addressed via regulation given that regulatory focus was on addressing the shareholder-manager tension.

While command of the markets may provide one explanation for the irrelevance of the shareholders of 77% of the listed firms at the time, there may be another reason why the liberals of those days did not concern themselves with this group of shareholders. The reason may, arguably, rest with the investment theory of the day.

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<sup>38</sup> Berle and Means, *Modern Corporation*.

The Harvard economist Thomas Carver, for example, provided guidance to investors in 1925, suggesting that small investors (a class covering employees and/or those with modest incomes) should generally restrict their investments to shares of firms that are considered “dependable.”<sup>39</sup> Here, “dependable” firms appear to be firms that are well advanced in their corporate life cycle. As for all other public shares (likely referring to small- and medium-sized firms),<sup>40</sup> Carver argues that these investments are the lot of the expert investor, and, we can suppose, the speculator as well.

Once these smaller firms attain stability, Carver explained, “the original investors may be tempted to sell to small investors who are seeking safety and who are willing to pay a high price to get it; that is, who are willing to invest for very small returns.”<sup>41</sup> The result is that “[u]nder this general policy the old well established industries would be owned more and more by large numbers of small investors ... who are not in a position to take many chances with their investments.”<sup>42</sup> Thus, according to Carver’s advice, the larger a firm grows and matures, and its cash flows become more dependable, the firm’s blockholders may elect to sell their holdings (in whole or in part) and, as a result, the firm will become increasingly diffused – creating an inverse relationship between ownership concentration and size of the public firm.

Once we view Berle and Means and the fragmented ownership assumption underlying the regulatory measures adopted as part of the New Deal in the area of securities against the

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<sup>39</sup> Thomas Nixon Carver, “The Diffusion of Ownership of Industries in the United States,” *Proceedings of the Academy of Political Science in the City of New York* 11, no. 3 (1925): 45.

<sup>40</sup> I assume that Carver is talking about public shares in this context in light of the fact that his discussion, in general, is on the topic of public firms.

<sup>41</sup> Carver, “Diffusion of Ownership,” 46.

<sup>42</sup> *Ibid.*



investment framework advanced by Carver, we see that the 1934 Act catered to a certain type of investor (i.e., the fragmented investor) in a certain type of company (i.e., the fragmented large public corporation). As such, "public interest" can be seen to mean the interest of the working class that sought to participate in the distribution of income surplus by large public firms (which also formed FDR's voter pool).

This, however, gave rise to an imbalance within the regulatory framework governing the capital markets. The imbalance stems from the gap (or fault-line) in the framework between the views of ownership by the policymakers (and by extension the newly minted SEC) and the realities displayed in the marketplace.

#### **IV. PROXY RULES – THE OWNERSHIP-REGULATION NEXUS**

The regulatory imbalance just described, between the regulator's views of ownership patterns in the market that the typical firm is characterized by fragmented ownership, on the one hand, and realities displayed in the market that showed that the typical firm displayed block holdings, on the other, can be seen in the proxy rules found in s. 14(a) of the Securities Exchange Act of 1934.

One pre-1929 corporate practice that the 1934 Act sought to remedy was the disenfranchisement of shareholders by corporate managers via the proxy system. In order to avoid abuse of shareholders by managers who often asked for proxies without providing the former with information, s. 14(a) of the 1934 Act introduced the federal proxy rules which apply to publicly listed firms. "Section 14(a) of the Exchange Act gave the [SEC] almost plenary authority to regulate the proxy process."<sup>43</sup>

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<sup>43</sup> Brown, "The Regulation of Corporate Disclosure. § 2.01 Historical Overview."

The regulatory vision of the proxy rules found in s. 14(a) of the 1934 Act was the result of three forces that combined to create the regulatory vision. These three forces were distrust of management, distrust of corporate actors and financial markets, and concern for the protection of individual investors.<sup>44</sup> According to Pound, “the reform vision was essentially populist, aimed at empowering the small investor and thereby constraining those perceived to have excess power and privilege. I term the vision investor protection.”<sup>45</sup>

The proxy rules, however, as other sections of the 1934 Act, were based on the assumption that the appropriate tension to be resolved by regulation is the shareholder-manager tension and, consequently, the understanding that the typical firm was characterized by fragmented owners. In other words, the proxy rules addressed the concerns of shareholders in approximately 23% of the listed firms at the time, while failing to adequately address the concerns of the shareholders of the remaining 77% of the listed firms.

The above observations raise the following question: can the federal proxy rules function if the SEC’s enabling statute is unclear about the particular investor in whose interests it must act? A curious question to pose, yet, as Khademian pointed out, the enabling statutes provide the SEC with little guidance about which type of investor deserves regulatory protection: the retail investor, investors via funds, or the institutional investors.<sup>46</sup> According to Khademian the SEC resolves this dilemma by adopting a broad definition of public interest and, as such, defining

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<sup>44</sup> John Pound, "Proxy Voting and the SEC: Investor Protection versus Market Efficiency," *Journal of Financial Economics* 29, no. 2 (1991): 249.

<sup>45</sup> *Ibid.*

<sup>46</sup> Khademian, *The SEC*: 84-85.

“investor” broadly.<sup>47</sup> Such a broad definition, however, means that the SEC must navigate between different interests with the result that its rules inevitably favor one interest group over another.<sup>48</sup>

While this may be an undesirable feature of the system, when examined against the background of the proxy system another interesting observation comes to mind. Section 14 of the Securities Exchange Act of 1934 was introduced at a time when the equity markets were largely dominated by passive retail investors. Institutional investors’ investments during that period were largely confined to debt securities. Over the decades since the introduction of the proxy rules, the nature of the principal investor in the US equity markets experienced a transformation from the retail investor to the (often more active and activist) institutional one. Interestingly, however, the basic foundation of the proxy rules vis-à-vis the ownership structure of the typical American public firm remained the same.

This is an unsettling observation given that it means that although the balance of power in the equity markets experienced a shift, this shift is not reflected in the proxy rules – rules that are within the original responsibilities of the SEC.<sup>49</sup> This, in turn, raises the questions of whether the SEC is adequately performing its mandate under its enabling statute and the implications of this performance to both the SEC and the regulatory framework it oversees.

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<sup>47</sup> Ibid., 85-86.

<sup>48</sup> Ibid.

<sup>49</sup> As the SEC recently expressed in the Final Rule adopting Rule 14-11: “Regulation of the proxy process was one of the original responsibilities that Congress assigned to the Commission as part of its core functions in 1934.” SEC, Facilitating Shareholder Director Nominations 17 CFR Parts 200, 232, 240 and 249, at 9.

Recently, the proxy rules made headlines as a result of the 2008 economic crisis. The SEC, under the leadership of Mary Schapiro, was faced with a pressure to reform the regulatory framework governing the securities markets in the US in order to deal with externalities, such as systemic risk, that contributed to the crisis and, as such, to reduce the exposure of the regulatory framework to such externalities.<sup>50</sup> To these regulatory responses, Schapiro associated corporate voting:

Investors need accurate and comprehensive information not only when they trade but also when they vote, whether it is to elect directors, adopt compensation plans, approve transactions, or consider shareholder proposals. And so we have a variety of means to promote fair corporate voting.

Speaking for myself, I believe the SEC has not gone far enough in this latter area. And so I intend to make proxy access – meaningful opportunities for a company’s owners to nominate its directors – a critical part of the Commission’s agenda in the coming months.<sup>51</sup>

Thus, Schapiro linked the proxy rules, and corporate ownership, with regulatory responses to the 2008 economic crisis.

The discourse over proxy access, however, is new neither to regulatory nor academic circles in the US.<sup>52</sup> The debate raises issues of state corporate law and federal securities laws<sup>53</sup>.

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<sup>50</sup> Mary L. Schapiro, "Testimony Concerning Enhancing Investor Protection and Regulation of the Securities Markets. Before the United States Senate Committee on Banking, Housing and Urban Affairs (March 26, 2009)." US Securities and Exchange Commission, <http://www.sec.gov/news/testimony/2009/ts032609mls.htm>.

<sup>51</sup> Ibid.

<sup>52</sup> See, e.g., Joseph A. Grundfest, "The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law," *Business Lawyer* 65, no. 2 (2010); David F Larcker and Brian Tayan, "Proxy Access: A Sheep, or Wolf in Sheep's

However, these are not of concern to this study. This debate also raises political economy issues given that the principal supporters and advocates of the proxy access rules is a class of shareholders that consists mainly of institutional investors,<sup>54</sup> who have, for many years, sought to influence amendments to the proxy rules so as to increase their influence on corporate America.<sup>55</sup>

The fact that institutional investors are the principal supporters of the proxy access amendments raises the query as to why this class of investors supports such amendments. More particularly, what is it about the proxy rules that makes them so attractive to this class of investors. The nexus between these questions is the concept of public corporate ownership.

## V. METHODOLOGY, LIMITATIONS, AND OVERVIEW OF THIS STUDY

To unfold the relationship between public firm ownership and regulatory performance the study engages several fields of study.

### 1. Fields of Study

From a legal history perspective, the study analyzes the nature of public corporate ownership starting in the 1930s with the creation of the SEC to the 2010 passage of the much debated

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Clothing?," *Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in Corporate Governance No. CGRP-06(2010)*, <http://ssrn.com/abstract=1678063>.

<sup>53</sup> See, e.g., Grundfest, "SEC's Proposed Proxy Access Rules."

<sup>54</sup> *Ibid.*

<sup>55</sup> Mark A. Sargent and Dennis R. Honabach, "Proxy Regulation and the Corporation Governance Debate, § 1:1 Introduction," in *Proxy Rules Handbook* (Westlaw, 2011).

Dodd-Frank Act; this historical reconstruction serves as a basis on which to study the evolution of the legal responses adopted to meet the challenges particular to the structure of the U.S. capital markets over time. Importantly, the study argues, that in deviation from accepted wisdom in the corporate governance literature that considers the ownership structure in the US to be diffused, the ownership structure in the US can more appropriately be characterized by a special variant of the blockholder model. As a consequence, the study suggests various avenues of designing regulatory policy from both a historical and a comparative perspective.

From a comparative law perspective, the study suggests that the above findings allow for the re-consideration (or re-characterization) of the convergence/divergence debate of corporate governance rules at the international level, which occupied the fields in the two decades leading up to the 2008 financial crisis. Against this background, the study examines contemporary market intervention techniques from a corporate ownership perspective as it has been shaping market regulation in North America and Europe. With view to the argued need to develop regulatory instruments based on a comprehensive assessment of the underlying market structure, the thesis compares the ways in which both the SEC and capital market regulators, in European member states and at the EU level, have been conceptualizing and developing regulatory responses over time.

From a governance or institutional perspective, the study suggests that the focus of securities legislation on mitigating the shareholder-manager tension in the US, while side-lining the minority shareholder-blockholder tension, represents more than a mere imbalance in the regulatory framework. Such side-lining of the issue also assisted in the creation of a new species of systemic risk that is endogenous to the regulatory framework and originates with the SEC, which, in turn, raises questions about the ability of the SEC to meet its mandate of investor

protection. When examined against the background of the recent economic crisis, these observations provide for a sobering reflection on the regulatory reform debate surrounding the crisis.

## 2. Systems Analysis

Systems analysis in the context of legal studies was advocated for and popularized by Luhmann<sup>56</sup> and Teubner.<sup>57</sup> What this analytical tool offers is the tackling of complex, real-world, problems not adequately addressed by other reductionist approaches.<sup>58</sup> As Jackson explained

Complex problems involve richly interconnected sets of “parts” and the relationships between the parts can be more important than the nature of the parts themselves. New properties, “emergent” properties, arise from the way the parts are organized. Even if the parts constituting a complex situation can be identified and separated out, therefore, this may be of little help because the most significant features, the emergent properties, then get lost.

...

Systems thinkers advocate using “holism” rather than reductionism ... . Holism does not seek to break down complex problem situations into their parts in order to study them and intervene in them, rather, it respects the profound interconnectedness of the parts and concentrates on the relationships between them and how these often give rise to surprising

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<sup>56</sup> Niklas Luhmann, *Law As a Social System*, trans. Klaus A. Ziegert, Oxford Socio-Legal Studies (Oxford: Oxford University Press, 2004).

<sup>57</sup> Gunther Teubner, *Law as an Autopoietic System* (Oxford, UK; Cambridge, Mass., USA: Blackwell Publishers, 1993).

<sup>58</sup> Michael C. Jackson, *Systems Approaches to Management* (New York: Kluwer Academic/Plenum, 2000). 1.

outcomes – the emergent properties. Systems thinking uses models ... to try to learn about the behavior of the world ... .<sup>59</sup>

Adolf Berle, one of the authors of *The Modern Corporation and Private Property*, though not considered to be associated with the systems literature – neither by self-assignment nor by others – had made the point that in order to understand trends in the markets (or “emergent properties” in systems language), a student of the subject needs to adopt a broad view of the markets and the forces that shape them.<sup>60</sup> That is, Berle appears to have advocated a holistic approach to the markets – one that encompasses the understanding of the legal, economic, and political influences affecting such markets – as adopted in this study.

System thinking is used in this study in two instances. First, taking a holistic view of the capital markets, the analysis in Chapters 2-4 identifies how market actors’ behavior, as evidenced through corporate ownership, yields new emergent properties—or new forms of corporate ownership previously marginalized in the literature on corporate ownership that focuses mainly on the comparison of polar ownership situations (i.e., diffused ownership and concentrated ownership). Second, treating the regulatory framework governing the US securities markets as a system, the analysis in Chapters 5-6, respectively, (i) elucidates situations where “cause and effect are distant in time and space, and when the consequences over time of interventions are subtle and not obvious to many participants in the system”<sup>61</sup>—in the context of this Study, this situation arises through a mischaracterization of the nature of ownership in 1930s

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<sup>59</sup> Ibid., 1-2.

<sup>60</sup> Adolf Augustus Berle, *Power Without Property; A New Development in American Political Economy*, [1st ed. (New York.: Harcourt, 1959). 17-24.

<sup>61</sup> Peter M. Senge, "The Leader's New Work: Building Learning Organizations," *Sloan Management Review* 32, no. 1 (1990): 15.



which has consequences to regulation nearly 80 years onwards by allowing the SEC to serve as a source of risk to the very framework it was charged to protect; (ii) develops a regulatory quality improvement program—the Learning Regulator Framework—based on systems dynamics approaches to organizational learning.

### 3. General Attributes of a System

In general terms, a system has several core features. First, the system performs some function(s). Second, the system possesses the mechanisms required for achieving/ performing its function(s) and these mechanisms can evolve over time. Third, the sustainability of the system is dependent on its ability to carry out its function(s) in a consistent and stable manner over time, which requires the sustainment of a constant framework for the mechanisms which it operates (i.e., operational closure).<sup>62</sup> Fourth, the achievement of operational closure can be complicated and challenged by influences that may be either external or internal to the system. Thus, while the system is closed to the extent that it seeks to preserve its internal integrity (i.e., the framework by which it performs functions), it is open and vulnerable to influences from other systems (e.g., political and economic systems) and even changes within its own environment (i.e., the system is cognitively open).<sup>63</sup> Finally, as the system observes changes to, and instability in, its structural framework (be it due to internal or external factors), the system determines whether, and how, to respond.<sup>64</sup> The system may decide to adapt to the change and evolve. It may do so through the

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<sup>62</sup> See, generally, Luhmann, *Law As a Social System*: 76-139.

<sup>63</sup> *Ibid.*, 106-07.

<sup>64</sup> Micheler, in a discussion of the possible convergence between the German and English forms of corporate governance, noted:

process of self-reproduction (autopoiesis), whereby it evolves based on its existing framework. Alternatively, it may decide to preserve the status quo, and will apply its self-regulatory mechanisms (homeostasis or negative feedback) to restore its normal condition.<sup>65</sup>

As the system evolves over time, autopoiesis and homeostasis work harmoniously to achieve evolutionary improvements in the system while maintaining the stability and integrity of

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Law operates as a closed system subject to its internal dogmas. It responds to outside impulses but only by absorbing them through its doctrinal mechanisms. Legal doctrine limits the techniques available to a national legal system to respond to the pressure exercised by globalisation. ...

Globalisation will not cause any legal system to adopt the legal rules of another legal system in toto. For this reason, convergence can only occur on a functional level. ... Change, however, needs to be supported by national doctrinal rules. ...

These doctrines can also be changed to accommodate new challenges. The point made in this article is, however, that a jurisdiction, having selected one of these various doctrines at a crucial time, thereby imposes constraints on subsequently altering that choice. This is because a change of doctrinal tools creates uncertainties which any jurisdiction would be reluctant to accept irrespective of whether the different choice appears more appropriate or efficient.

Eva Micheler, "English and German Securities Law: A Thesis in Doctrinal Path Dependence," *Law Quarterly Review* 123, no. Journal Article (2007): 283-85.

<sup>65</sup> Negative feedback process or homeostasis is a self-regulating process, which enables systems to continue and operate based on their own logic and provides stability to the system. Luhmann, *Law As a Social System*: 255.

the system as a whole.<sup>66</sup> The decisions made by the system are also path dependent (i.e., future decisions are based on decisions taken in the past).<sup>67</sup>

According to Luhmann,<sup>68</sup> the above features of the system serve to reduce risk within the system. The reduction of systemic risk is achieved through the stabilization of normative expectations. Yet, the ability of the law to stabilize normative expectations may be declining due to the temporalisation of the law (i.e., the law is only valid until further notice).<sup>69</sup> The problem of temporalisation increases when legal norms are subject to internal or external errors. An example of an internal error is the presumed validity of certain facts that may be altered at a later stage, which could give rise to the reversal of decisions made based on the original facts. An example of external errors is the passing of legislation by the political system based on its construction of a social problem, only to pass new legislation when the problem is reformulated. The temporalisation issue leads to awareness that the legal system may itself be the source of risk. According to Luhmann, the legal framework responds to this risk by learning and evolving. According to Teubner, the legal system learns and evolves through “coupling of episodes”:

The mechanism at work can be called "coupling of episodes" ... . This mechanism is responsible for the evolutionary capacity of law, since it makes possible that legal selections

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<sup>66</sup> Gennady Shkliarevsky, "The Paradox of Observing, Autopoiesis, and the Future of Social Sciences," *Systems Research and Behavioral Science* 24, no. 3 (2007).

<sup>67</sup> S. J. Liebowitz and Stephen E. Margolis, "Path Dependence, Lock-In, and History," *Journal of Law, Economics, and Organization* 11, no. 1 (1995).

<sup>68</sup> Luhmann, *Law As a Social System*: 472. See also Richard Nobles and David Schiff, "Introduction," in *Law as a Social System*, ed. Niklas Luhmann, et al. (Oxford: Oxford University Press, 2004), 48.

<sup>69</sup> Luhmann, *Law As a Social System*: 469.

can be stabilized beyond the particular legal episode. It is via this mechanism that learning within legal episodes becomes evolution of the legal system.

Each single legal episode is in itself an autonomous social system. The particular legal proceeding uses the legal code, has a particular history, forms its peculiar structures. However, legal episodes are transitory, they need to be related to each other if a permanent legal system is to emerge. Coupling of episodes means that structures which have been built up within one legal episode can be utilized in future episodes.<sup>70</sup>

#### 4. Feedback Processes

Luhmann, in a discussion of the legal system as a system, observed two operations that could affect the stability of the legal system: negative feedback and positive feedback.<sup>71</sup> The system's application of negative feedback—basing future laws (both statutory and judge-made) on “existing rules, which are applied over and over again”—results in stability in the system. The system's application of positive feedback—basing future laws based on a deviation from existing knowledge—results in system instability and requires re-stabilization. Luhmann characterized positive feedback as a deviation process and negative feedback as a deviation correction process.

We can apply Luhmann's discussion to the level of a regulatory framework (i.e., a sub-system of the legal system). Bardach, for example, observed that the regulatory process operates in a negative feedback fashion.<sup>72</sup> Unlike Luhmann, however, he considers the positive feedback

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<sup>70</sup> Gunther Teubner, "Evolution of Autopoietic Law," in *Autopoietic Law: A New Approach to Law and Society*, ed. Gunther Teubner (Berlin ; New York: W. de Gruyter, 1988), 235.

<sup>71</sup> Luhmann, *Law As a Social System*: 255.

<sup>72</sup> Eugene Bardach, "Policy Dynamics," in *The Oxford Handbook of Public Policy*, ed. Michael Moran, Martin Rein, and Robert E. Goodin (Oxford; New York: Oxford University Press, 2006), 342.

process to constitute the system's endogenous learning process.<sup>73</sup> To reconcile Luhmann's view of the positive feedback process—deviation—with that of Bardach—learning, it is suggested that in the context of regulation, events giving rise to positive feedback are better viewed as legal errors that necessitate learning and, thus, correction. This view provides a better explanation to Bardach and Kagan's concept of "regulatory ratchet"—by which they apply the combination of political pressure and bureaucratic tendencies that may constrain regulatory evolution and the withdrawal of rules once adopted, leading to an over-encumbered system.<sup>74</sup> Regulatory ratchet, in a sense, leads to rule and rule-making path dependency that hinders learning.

## **B. LIMITATIONS OF THE STUDY**

The study attempts to examine the impact of the SEC's perceptions of the concept of public firm ownership on (i) the regulatory process and (ii) the SEC's learning. The SEC, as is the case for other independent administrative agencies in the US, is a product of both law and politics. The influence of these two institutions or systems gives rise to pressures and tensions within the SEC that find translation in the organization's operative and normative programs. This study does not delve into the various aspects of the political economy process and its impact on regulation to any great extent—aspects that have been recognized since at least the 1950s.<sup>75</sup> Rather, this study assumes the exposure of the SEC to interest group pressures as a given. The reason is that while political economy explanations may serve to explain the impact of partisan and interest group

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<sup>73</sup> Ibid., 346.

<sup>74</sup> Eugene Bardach and Robert A. Kagan, *Going by the Book: The Problem of Regulatory Unreasonableness* (Philadelphia: Temple University Press, 1982).

<sup>75</sup> For early comments on the exposure of the independent administrative agency to interest groups see, e.g., Marver H. Bernstein, *Regulating Business by Independent Commission* (Princeton, N.J.: Princeton University Press, 1955).

influences on the SEC in the context of the post-2008 financial crisis reforms,<sup>76</sup> they do not assist in the analysis of *whether* the agency missed learning opportunities vis-à-vis a fundamental concept such as ownership.

Relatedly, the regulatory process involves decisions made by individual members of the SEC. This study, however, treats the SEC as a unit separate from its members and individual decision-making by members is attributed to the institution. This issue was described by Hutter as the problem of “seeing”—whether we view regulatory agencies as units independent of their members or as consisting of a collection of members each having interests that impact the institution’s decision-making process.<sup>77</sup> Thus, while both institutions and their members learn in their respective capacities, they are as Fiol and Lyles observed, different:

Though individual learning is important to organizations, organizational learning is not simply the sum of each member's learning. Organizations, unlike individuals, develop and maintain learning systems that not only influence their immediate members, but are then transmitted to others by way of organization histories and norms ... Learning enables organizations to build an organizational understanding and interpretation of their environment and to begin to assess viable strategies.<sup>78</sup>

The approach to learning adopted in this study is that of cultural learning. Rather than looking at the cognitive processes leading to the decision, learning is assessed through decision-

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<sup>76</sup> John W. Cioffi, *Public Law and Private Power: Corporate Governance Reform in the in the Age of Finance Capitalism*, Cornell studies in political economy (Ithaca N.Y.: Cornell University Press, 2010). 210.

<sup>77</sup> Bridget Hutter, “‘Ways of Seeing’: Understandings of Risk in Organizational Settings,” in *Organizational Encounters with Risk*, ed. Bridget Hutter and Michael Power (Cambridge: Cambridge University Press, 2005).

<sup>78</sup> C. Marlene Fiol and Marjorie A. Lyles, “Organizational Learning,” *Academy of Management Review* 10, no. 4 (1985): 804.

making outcomes—and hence resulting gaps in the regulatory framework.. As such, the study did not necessitate interviewing SEC members on the manner in which decisions are made at the commission.

The study is principally US-centric. While Chapter 2 of this study lays the foundation for such comparative analysis, this analysis is not pursued further in later chapters. Future research building on insights offered in this study would benefit from exploring the impact of the findings offered in this study on such comparative analysis. In addition, the study, though acknowledging differences between the various types of institutional investors (e.g., in terms of activism), treats these investors as a single entity. This was done in consistency with the SEC's approach to institutional investors in the context of the federal proxy rules—as in the case of the SEC Proxy Access Rule—which does not differentiate between activist and non-activist investors.

### **C. ORGANIZATION OF THIS VOLUME**

The engagement with these concepts in this volume is achieved through five self-contained published articles that collectively form a case study that seeks to examine the nexus between ownership and regulation by tracing the evolution of rule 14a-11 or as it is referred to in the articles, the SEC Proxy Access Rule<sup>79</sup>, from the proposal stages to the final rule.

The volume is divided into two main parts. Chapters 2 to 4 examine public firm ownership in the US and seek to determine (i) trends in such ownership, (ii) the significance of institutional investors as blockholders, and (iii) the roles of private equity and institutional investors in the ownership trend identified in Chapter 2, as well as, introduce fault-lines in the

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<sup>79</sup> Facilitating Shareholder Director Nomination 17 CFR Parts 200, 232, 240 and 249.

regulatory framework governing the securities markets, respectively. Chapters 5 and 6 describe in greater details the implications of the fault-lines identified.

A reader seeking legal analysis of the SEC Proxy Access Rule is encouraged to consult with other texts on the matter, as this type of analysis is not within the purview of this study. The analysis here seeks only to understand whether the SEC is a learning organization through examination of the agency's view of the concept of ownership.

## **VI. INTENDED AUDIENCE**

The study will appeal to a broad readership with interest in regulation and governance. It will be of interest to anyone conducting research on corporate ownership and on the performance of administrative agencies such as the SEC. This broad readership includes academics, practitioners, and students in areas such as business, economics, finance, law, public administration and management, political science, and regulation. The study is targeted at readers in the fields of law and public administration where the topics of (i) corporate governance, (ii) corporate ownership, (iii) regulation, and (iv) public administration are studied. The text is written in a manner that is accessible to a variety of readers from undergraduate to graduate students, established academics, as well as practitioners in the area.



## **CHAPTER 2, THE NATURE OF CORPORATE OWNERSHIP IN THE USA:**

### **THE TREND TOWARDS THE MARKET ORIENTED BLOCKHOLDER**

#### **MODEL\***

This chapter examines the assumption that the ownership pattern in the US public firm is aptly characterized as diffused and argues that the evolutionary trend in the US has been towards a hybrid ownership structure, which I refer to as the Market Oriented Blockholder Model (MOBM). Under the model, it appears that market forces in the US equity markets have been pushing towards a state of ownership structure that affords the benefits of (i) increased monitoring (associated with the concentrated ownership model) and (ii) increased liquidity in the capital markets (associated with the dispersed ownership model). Implications of the MOBM to the convergence/divergence debate are also discussed.

#### **I. INTRODUCTION**

It has been suggested that nations and their citizens are not fully reaping the theoretical benefits of financial globalization.<sup>1</sup> Some argue that the global divergence in corporate governance

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<sup>1</sup> See, e.g., David Dickinson, "Financial Markets and Global Integration," in *50 Years of EU Economic dynamics: Integration, Financial Markets, and Innovations*, ed. Richard H. Tilly, Paul J. J. Welfens, and Michael Heise (Berlin; New York: Springer, 2007). But see Ernst & Young, inter alia, arguing capital markets have become increasingly globalized and interdependent, and that in emerging markets 600 million individuals attained middle

structures is an obstacle to financial globalization.<sup>2</sup> As the literature on corporate governance informs us, while most national economies (both developed and developing) display concentrated forms of corporate ownership structures, the US displays dispersed ownership structures.<sup>3</sup> Importantly, this traditional narrative assumes that the US capital markets can properly be characterized as a dispersed ownership economy.

This chapter examines this assumption and shows that, contrary to this assumption, as US equity markets grew in complexity and matured during the 20th-century they gravitated towards a hybrid form of corporate ownership structure; referred to in this chapter as the Market Oriented Blockholder Model (MOBM). The primary feature of the MOBM is its blockholder levels of corporate public ownership.<sup>4</sup> These ownership levels are significant because they make it

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class status in these economies since 2000, with an estimated projected annual growth of 70 million individuals per year. Ernst & Young, "Global Megatrends 2009," (EYGM Limited, 2009).

<sup>2</sup> See, e.g., René M. Stulz, "The Limits of Financial Globalization," *Journal of Applied Corporate Finance* 19, no. 1 (2007). See also comment by Wymeersch: "ownership structure seems the single most significant variable factor in explaining differences in governance structures." Eddy Wymeersch, "Convergence or Divergence in Corporate Governance Patterns in Western Europe," in *Corporate Governance Regimes: Convergence and Diversity*, ed. Joseph A. McCahery, et al. (Oxford; New York: Oxford University Press, 2002), 240..

<sup>3</sup> The UK is another noteworthy example of an economy that is characterized by dispersed ownership structures, though the focus of this chapter is on the US economy.

<sup>4</sup> Given that the literature on corporate ownership structures does not make an explicit differentiation between the concentrated and the blockholder modes of ownership (and they are generally used interchangeably), for the sake of clarity, I divide the spectrum of public firm ownership into three clusters: concentrated ownership represents ownership levels in excess of 50.1% of the firm's outstanding shares; blockholder ownership represents ownership levels between 5% and 50%; and dispersed ownership represents ownership level below the 5% levels. The choice of the 5% threshold is based on the disclosure filing requirements under s 13(d), Securities Exchange Act of 1934,

possible to better integrate mechanisms for achieving two functions of corporate governance: (1) the monitoring of management function (generally made possible under conditions of concentrated ownership),<sup>5</sup> and (2) the development of efficient and liquid markets (generally made possible under conditions of dispersed ownership).

Identification of the MOBM is important for at least two reasons. First, it provides for a theoretic description of the US corporate ownership structure, based on historical trends and accounts, which better reflects market realities. Second, some observers in the literature on corporate governance note a trend from state to markets in continental Europe and Japan vis-à-vis systems of economic governance, and “[i]n the field of corporate governance, a greater degree of outsider control is gradually being introduced into systems that have hitherto been mostly insider-controlled.”<sup>6</sup> In other words, it appears that we are witnessing a global trend

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15 U.S.C.A. Ch. 2B, that requires, inter alia, disclosure of beneficial ownership of 5% or more by any person of the outstanding shares of a firm’s securities subject to Securities Exchange Act. One should note, however, that while the above are used as a general guide, these lines of demarcation are fluid and are subject to change from one firm to another based on factors such as size of the firm and shareholdings of individual investors.

<sup>5</sup> An important feature of the MOBM that accommodates this function is that it works harmoniously with market mechanisms, such as the market for corporate control. For a discussion of the market for corporate control see, e.g., Henry G. Manne, "Mergers and the Market for Corporate Control," *Journal of Political Economy* 73, no. 2 (1965). This is important because economies characterized as having concentrated or blockholder modes of ownership are generally said to have a weak market for corporate control. See, e.g., Bebchuk and Hamdani, "Elusive Quest.," Lucian A. Bebchuk and Mark J. Roe, "A Theory of Path Dependence in Corporate Ownership and Governance," *Stanford Law Review* 52, no. 1 (1999); Mark J. Roe, "German Codetermination and German Securities Markets," *Columbia Journal of European Law* 5, no. 2 (1998).

<sup>6</sup> Heike Schweitzer and Christoph Kumpan, "Changes of Governance in Europe, Japan, and the U.S.: Discussion Report," in *Corporate governance in context : corporations, states, and markets in Europe, Japan, and the US*, ed.

towards a US-style mode of ownership. The presumption here is that such a move will lead, inter alia, to the adoption of laws and institutions that will result in improved corporate governance for the sake of encouraging increased capital inflows and economic growth—where such an adoption will include the promotion of diffused ownership within the particular economy's public equity markets. Assuming that such observations are valid, an international shift towards the MOBIM could make it possible to achieve a functional convergence of corporate ownership models globally, due to the hybrid nature of the MOBIM.

This chapter is structured as follows. Sections II and III, respectively, examine evolution of public firm ownership in the USA in two stages: 1930s to early 1960s, and early 1960s to the

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Klaus J. Hopt and et al. (Oxford; New York: Oxford University Press, 2005), 693. See also Marco Becht and J. Bradford DeLong, "Why Has There Been So Little Block Holding in America?," in *A History of Corporate Governance around the World: Family Business Groups to Professional Managers*, ed. Randall Morck (University of Chicago Press, 2005). Becht and DeLong noted, inter alia, that there are signs of global convergence towards a US-style of corporate governance, and that convergence with respect to ownership structure of firms, i.e., diffused ownership, is probable due to the ease of capital raising that this structure affords. Brian R. Cheffins, "Does Law Matter? The Separation of Ownership and Control in the United Kingdom," *The Journal of Legal Studies* 30, no. 2 (2001): 461. John C. Jr. Coffee, "The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications," *Northwestern University Law Review* 93(1999). Coffee argued that functional convergence towards a US-style of corporate governance is occurring. Henry Hansmann and Reinier Kraakman, "Toward a Single Model of Corporate Law," in *Corporate Governance Regimes: Convergence and Diversity*, ed. Joseph A. McCahery, et al. (Oxford; New York: Oxford University Press, 2002). Hansmann and Kraakman noted (at 56) that there is evidence of convergence towards the shareholder-oriented model of corporate governance that is generally associated with the US and UK. And Peer Zumbansen, "Varieties of Capitalism and the Learning Firm: Contemporary Developments in EU and German Company Law: A comment on the Strine-Bainbridge Debate about Shared Values of Corporate Management and Labor," *CLPE Research Paper No. 21* (2007), <http://www.comparativeresearch.net/jsp/abstract.jsp?paperid=10000044>.

present.<sup>7</sup> These stages (which are not mutually exclusive and are overlapping) offer a common thread: they allow us to trace the movement/flow of share ownership over time (where 'movement/flow' refers to the change in the character of ownership from one type of investor to another). The analysis takes a holistic view of the US public equity markets (i.e., it takes into account (i) all publicly traded firms as opposed to a fragment of these markets representing large firms, and (ii) different types of investors, such as retail, institutional and family); in contrast to alternative existing studies that tend to focus on selected fragments within the equity markets. This type of analysis (i.e., historical and holistic) makes it possible to capture market dynamics vis-à-vis share ownership in the USA over a period that is sufficiently long to discern trends. In particular, it reveals the emergence of the MOBM.

Section IV provides some observations in relation to the trend towards the MOBM. Section V identifies the opportunities that the MOBM creates for convergence, and the need for mobilizing political and legal measures necessary to facilitate this convergence. Section VI offers some concluding remarks.

## **II. STAGE I: "DISPERSED" OWNERSHIP**

Two notable trends in the character of corporate ownership of the American public firm took place in the period between the 1930s and the 1960s. The first trend involved changes in patterns of ownership, from concentrated to 'dispersed'. The second trend involved a shift from industrial capitalism to financial capitalism. This section of the chapter describes these trends. To better

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<sup>7</sup> The division of the timeline into three stages is consistent with Davies Paul L. Davies, *Gower & Davies' principles of modern company law*, vol. 7th (London: Sweet & Maxwell, 2003). 337.

appreciate the contexts of these trends, the discussion begins with a brief description of events leading up to the 1930s.

#### A. OWNERSHIP OF THE AMERICAN PUBLIC FIRM UP TO THE 1930s

During the 19th and early 20th centuries, wealth in the USA was concentrated in the hands of few industrialists<sup>8</sup> who shaped the American approach to investment oversight.<sup>9</sup> Using the Corporate form of organization,<sup>10</sup> they increasingly sought to raise funds from a growing pool of public investors – a practice that resulted in the dispersion of ownership in public firms.<sup>11</sup>

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<sup>8</sup> See, e.g., George Gunton, "The Economic and Social Aspect of Trusts," *Political Science Quarterly* 3, no. 3 (1888); Arthur T. Hadley, "How Far Have Modern Improvements in Production and Transportation Changed the Principle That Men Should Be Left Free to Make Their Own Bargains? I," *Science* 7, no. 161 (1886); JACF, "Morgan Stanley Roundtable on Private Equity and Its Import for Public Companies," *Journal of Applied Corporate Finance* 18, no. 3 (2006); Michael C. Jensen, "Eclipse of the Public Corporation," *Harvard Business Review* 67, no. 5 (1989); H. T. Newcomb, "The Concentration of Railway Control," *Annals of the American Academy of Political and Social Science* 19, no., Commerce and Transportation (1902); Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton, N.J: Princeton University Press, 1994); Henry Wade Rogers, "Corporations," *Yale Law Journal* 11, no. 5 (1902).

<sup>9</sup> John Pound, "Raiders, Targets, and Politics: The History and Future of American Corporate Control," *Journal of Applied Corporate Finance* 5, no. 3 (1992).

<sup>10</sup> For industrialists, the corporate form, which emerged in the early part of the 19th century, offered the flexibility "to secure the requisite capital from a number of small investors" and accumulate their wealth Hadley, "How Far," 221.. Hadley noted two other factors that aided in the accumulation of power via the corporation: technology/product (i.e., the steam engine) in the markets for the technology/product (i.e., transportation).

<sup>11</sup> See, e.g., *ibid.*, 222.

By 1925, the business and academic communities were describing the rise of dispersed ownership in the large American public corporation as an economic revolution<sup>12</sup> – a trend that might have been shaped by public opinion.<sup>13</sup> This revolution was also the first sign of the rise of financial, as opposed to industrial, capitalism. As such, “it marked the beginning of a new and very important trend in the character of ownership of equity investments.”<sup>14</sup>

More specifically, the observable trend was that “every responsible adult is tending to become directly – over at one remove, through the savings bank or insurance company – interested in corporate conduct in corporate profits.”<sup>15</sup> Thus, concerned observers were beginning to view share ownership via institutional investors, such as insurance companies, as a tool or vehicle for facilitating the fragmentation in ownership of the US public firm.<sup>16</sup> This is

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<sup>12</sup> Carver, "Diffusion of Ownership." But Stimson suggested that the fragmentation of ownership was an evolution rather than a revolution. Henry L. Stimson, "The Effects of Popular Ownership on Public Opinion," *Proceedings of the Academy of Political Science in the City of New York* 11, no. 3, Popular Ownership of Property: Its Newer Forms and Social Consequences (1925).

<sup>13</sup> As Stimson observed, “[j]ust as public opinion control the operation of our laws, so it more and more controls the conduct of our industries. Upon that public opinion the new proprietorship is producing and most potent change.” —, "Effects of Popular Ownership," 136.

<sup>14</sup> Ragnar D. Naess, "Changing Patterns of Individual Equity Investment," *Financial Analysts Journal* 20, no. 4 (1964): 75-76. In the three years following the market crash of 1929, common stock investments were not deemed attractive for either individual or institutional investors (*ibid*, 76).

<sup>15</sup> Robert S. Binkerd, "The Increase in Popular Ownership Since the World War," *Proceedings of the Academy of Political Science in the City of New York* 11, no. 3 (1925): 37.

<sup>16</sup> See, e.g., Carver, "Diffusion of Ownership."; Robert Lynn Cox, "Policy-Holder Ownership and Interest Through Investment of Life Insurance Funds," *Proceedings of the Academy of Political Science in the City of New York* 11, no. 3 (1925).

despite the fact that the insurance companies at the time appear to have been investing principally in the securities.

As we shall see in the remainder of Section II and in Section III of this chapter, however, contrary to the impression is created in 1925 vis-à-vis institutional investors as factors in the separation of ownership from control, the growth of institutional investors who constitute “a partial re-concentration of shareholdings ... into the hands of ‘institutional’ shareholders, especially pension funds and insurance companies.”<sup>17</sup>

## **B. BERLE AND MEANS AND THE CORPORATE PARADIGM OF AMERICAN CAPITALISM**

By the 1930s, Berle and Means observed that the wealth and power in America was concentrated in that country's largest corporations.<sup>18</sup> This concentration of wealth and power was accompanied by the dispersion of ownership in these firms.<sup>19</sup> These findings gave rise, inter alia,

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<sup>17</sup> Davies, *Gower & Davies*, 7th: 337.

<sup>18</sup> Berle and Means, *Modern Corporation*. It would appear that the Berle and Means' book was actually concerned with the growth of giant corporations. But it “is remembered not as the book that called attention to corporate power, but is a book that called attention to the separation of ownership from control in large public corporations” Dalia Tsuk, “From Pluralism to Individualism: Berle and Means and 20th-Century American Legal Thought,” *Law & Social Inquiry* 30, no. 1 (2005): 180.

<sup>19</sup> Berle and Means, *Modern Corporation*: 47-68. Berle and Means noted (at 56) that dispersion was aided, inter alia, by an increase in employee and customer ownership of the public corporation partly because of the disadvantageous tax treatment of wealthy individuals. However, as they noted (at 59), “[f]actors other than taxation must have played a part in the rise and partial decline of these two movements.”



to concerns over the potential for divergence of interests between the owners and the managers of the corporation.<sup>20</sup>

During the ensuing years since the publication of *The Modern Corporation and Private Property*, commentators appear to have busied themselves with attempts to fill gaps in Berle and Means' study and correct any errors in it. In light of the profoundness of Berle and Means' observation, we should examine their study more closely along with other developments during this period (where such a survey is limited to the growth of institutional investors).

The literature on corporate governance appears to have treated Berle and Means' observations about a particular segment of the capital markets—large public companies—as generalizations about the remainder of the firms in these markets. The observation was that ownership in these firms had become dispersed. As some have noted, “Berle and Means recognized what was to become the dominant corporate paradigm of 20th-century American capitalism”<sup>21</sup>

Viewing Berle and Means' observations as a paradigm carries an inherent risk. In order to appreciate this claim, we first need to understand what we mean when we refer to something as a “paradigm.” Jacobs commented on the use of the term ‘paradigm’ vis-à-vis corporate governance:

When we use that term, we refer to an idealized portrait or mind-picture of how the world, or some aspect thereof, operates. *A paradigm, however, is a model, not reality, but we treat paradigms as if they were real*, in order to have a conceptual foundation upon which to

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<sup>20</sup> Ibid., 7-8.

<sup>21</sup> Franklin R. Edwards and R. Glenn Hubbard, "The Growth of Institutional Stock Ownership: A Promise Unfulfilled," *Journal of Applied Corporate Finance* 13, no. 3 (2000).

develop a body of rules ... to predict and to regulate the phenomena that are the subject of the paradigm.<sup>22</sup> [Emphasis added]

Accordingly, the treatment of Berle and Means' observations as a paradigm carries with it the risk of failing to grasp accurately how the capital markets operate as a whole in reality, thereby opening a window for the introduction of distortions into the analysis. For example, the generalization of Berle and Means' analysis to encompass the entire body of public firms overlooks or understates Berle and Means' observation vis-à-vis small and medium sized public companies (SMPCs). These SMPCs featured blockholders along with smaller (dispersed) investors.

Berle and Means did not concern themselves with SMPCs and deemed them relatively "unimportant" since they did not command any significant portion of total assets in the market.<sup>23</sup> Importance in this context appears to refer to the ability to exert power through market dominance. A further reading of their text reveals that these relatively unimportant firms constituted the majority of the firms listed.<sup>24</sup> These observations led Berle and Means to conclude that the larger the firm's size the more dispersed it became.<sup>25</sup> Nevertheless, the large

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<sup>22</sup> Jack B. Jacobs, "Paradigm Shifts in American Corporate Governance Law: A Quarter Century of Experience," *Corporate Governance Advisor* 15, no. 5 (2007).

<sup>23</sup> Berle and Means, *Modern Corporation*: 28.

<sup>24</sup> For example, out of 573 corporations on the New York stock market on 9 March 1929, Berle and Means observed that the largest 130 firms accounted for 81.7% of the total assets, while the remaining 443 accounted for only 18.3% of the total assets (*ibid.*, 27.). The 443 firms, however, constituted more than 77% of the listed firms.

<sup>25</sup> *Ibid.*, 52. This is consistent with both Carver, "Diffusion of Ownership," 45-46. and modern theories of the firm, for example, Harold Demsetz and Kenneth Lehn, "The Structure of Corporate Ownership: Causes and Consequences," *Journal of Political Economy* 93, no. 6 (1985). Demsetz and Lehn noted that the larger the size of

firms only represented a minority, and, as such, it would appear that block holdings (accompanied by smaller shareholders) in SMPCs was the prevalent mode of ownership.<sup>26</sup>

The separation of ownership from control in large firms had another related consequence. It paved the way for the transfer of share ownership from the individual investor to the institutional investors – a process not predicted by Berle and Means.

### **C. FROM INDIVIDUAL TO INSTITUTIONAL INVESTORS**

Apart from the observation that public firms in the USA, when looked at as a whole, displayed block holdings, another trend should be noted. A new type of equity owner was rapidly growing. This was the institutional investor (e.g., mutual funds, pension funds and insurance companies). The importance attached to institutional investors in the literature can be understood when examined in the context of their development. As Naess observed,

The period from 1932 to 1937 ushered in a new awareness of importance of broad social changes needed to meet the problems of insecurity and unemployment. This resulted in new legislation on a scale that led many people to call the period one of 'peaceful revolution.' As a result of the social changes taking place, new institutions emerged in the financial field such as social security funds, pension funds and mutual funds which could, in part, help meet the serious problems of insecurity from unemployment, old age and inflation. These

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the firm and, as a result, its capital requirements, the greater is the likelihood that the firm will be diffused. This, they noted, results in an inverse relationship between firm size and ownership concentration.

<sup>26</sup> The marginalization of the majority of the public firms by Berle and Means may have had its roots in the fact that they wanted to emphasize their conclusions vis-à-vis large firms. A discussion of this point, however, is beyond the scope and purpose of this chapter.

institutions and others ... began to take a much more active interest in common stock investments than they did in former years.<sup>27</sup>

Institutional investors began increasing their exposure to equity investments during the 1950s, following World War II and the Korean War.<sup>28</sup> Towards the end of the 1950s, individuals became, on balance, the sellers of common stock, excluding their holdings in mutual funds, whereas institutional investors increased their purchases of common stock.<sup>29</sup> Indeed, the observed pattern during the period was that individuals were shifting their capital from direct share ownership to institutional investments and bank deposits.<sup>30</sup>

Adolf Berle, one of the authors of *The Modern Corporation and Private Property*, commented in 1968 on the growth of the institutional investor:

Surely the most spectacular development is the emergence of a new concentrated power countervailing that of corporate management ... In recent years, stock has become more and more concentrated in the hands of institutional investors ... such a concentration of power is a very dangerous thing from the point of view both of the public and corporate management

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<sup>27</sup> Naess, "Changing Patterns," 77. See also Charles H. Schmidt and Eleanor J. Stockwell, "The Changing Importance of Institutional Investors in the American Capital Market," *Law and Contemporary Problems* 17, no. 1, Institutional Investments (1952). The growth of institutional investors during the 1930s resulted, according to some, in a measure of significance attached to them by such governmental institutions as the Securities and Exchange Commission (SEC): "the welfare of the institutional investor has attracted more attention than the welfare of the investors to whom he sells." Editorial, "The Meaning of "Control" in the Protection of Investors," *Yale Law Journal* 60, no. 2 (1951): 321.

<sup>28</sup> Naess, "Changing Patterns," 78.

<sup>29</sup> Ibid.

<sup>30</sup> It is conceivable that institutional investors' appetite for quality investments resulted in a shortage of such investments (both in terms of quantity and affordability) for individual investors.

... The way things are now going we will soon have an economy dominated by fiduciaries  
... The current estimates—it frightens me—is that by 1970 institutional investors will hold  
*one-third* of the stock of all corporations listed on the New York Stock Exchange. That adds  
up to working control.<sup>31</sup> [Emphasis in the original]

Thus, institutional investors, as investors, were about to become a feature of America's  
largest public firms.

A brief examination of the mutual fund industry during the period of 1930–1960, which  
has its genesis in the Massachusetts Investors Trust of 1924,<sup>32</sup> serves to illustrate the point. On  
30 June 1941, 141 mutual funds were registered with the SEC pursuant to the Investment  
Company Act of 1940 with net aggregate assets of \$448 million. By 31 December 1961, the  
number of registrants rose to 344 firms commanding more than \$24 billion in net aggregate  
assets.<sup>33</sup> Seventy-five per cent of the total net assets of the funds were held in US common stock,  
representing approximately 3.5% of the total value of all stocks listed on the New York Stock  
Exchange (NYSE).<sup>34</sup> Over 75% of the stock purchases by the funds were effected on the NYSE,

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<sup>31</sup> G. R. Rosen, "The New Realities of Corporate Power," *Dun's Review* 1968, 43-44. The concept of "working control" is related to that of Berle and Means' concept of "minority control" (Berle and Means, *Modern Corporation: 79-80.*) – both concepts mirror what we call today "blockholders."

<sup>32</sup> Wharton School, United States Securities and Exchange Commission, and United States Congress. House. Committee on Interstate and Foreign Commerce, *A Study of Mutual Funds*, House report (Washington: U.S. G.P.O., 1962). 4.

<sup>33</sup> *Ibid.*, IX.

<sup>34</sup> *Ibid.*, XI. The largest 20% of the funds in the study accounted for 78% of the total assets of all the funds combined.

with the remainder on the over-the-counter markets.<sup>35</sup> In addition, the Wharton Report found that the growth of the fund industry during the 1940s and 1950s had an upward influence on stock prices.<sup>36</sup>

The extent of control of portfolio firms by open-end companies (the abuse of which is a concern of the Investment Company Act of 1940) in 1958 is also revealing. The Wharton Report found that these investment firms owned (i) 1,611 holdings of 1% or more, (ii) 165 holdings of 5% or more, and (iii) 24 holdings of 10% or more. "In short, those holdings or open-end companies and groups which are of the greatest significance from the standpoint of control (those of 5 percent or over) more than doubled in number between 1952 and 1958."<sup>37</sup> In addition, "there were, at a minimum, some 39 holdings that were large enough ... to have the potential for influencing portfolio company management."<sup>38</sup>

In light of the size of their holdings, mutual funds, as in the case of other institutional investors, have come under criticism "for failing to function as active and independent stockholders, and for tending to lend uncritical support to existing management."<sup>39</sup> The reason

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<sup>35</sup> Ibid., 13.

<sup>36</sup> Ibid., 21.

<sup>37</sup> Ibid., 24. The report also noted one case in which a fund acquired shares for the purposes of obtaining control over a portfolio company (ibid., 427.). Mutual funds in the USA are regulated under the Investment Company Act of 1940, which limited the ability of diversified investment firms to concentrate their holdings in any one portfolio firm. This limitation applied to 75% of the investment company's total assets. The exemption of 25% of the investment company's total assets from the 5 and 10% rule was to encourage investment in small companies and illiquid shares (ibid.).

<sup>38</sup> Ibid., 25.

<sup>39</sup> Ibid., 26.

given by fund managers for this support is that they had confidence in the management of portfolio companies, and that when such confidence was lost the fund usually reduced or liquidated its holdings in that company. That is, fund managers vote with their feet.<sup>40</sup>

Some observers found fault in the exercise of the “Wall Street Rule” by institutional investors. For example, Livingston commented that by voting with its feet

the shareholder abandons his right to improve management. ... He passes to someone else a stock certificate he regards as faulty ... In which case, the only check on the management is the threat that the price of the stock will decline and some intruder ... may buy up the shares at a depreciated price and try to take over the company. If no such “raider” comes along, the average stockholder is left holding the bag of managers that Wall Street says are not very good.<sup>41</sup>

Thus, Livingston concluded, institutional investors (who, for Livingston, were as important as large individual shareholders in monitoring managers)<sup>42</sup> “are the trustees for all shareholders. They establish the moral tone in Wall Street.”<sup>43</sup>

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<sup>40</sup> The Wharton Report, however, did report instances where institutional investors participated in proxy contests in opposition to portfolio companies’ management (either independently or in concert with other mutual funds). Nevertheless, according to the report, “this number of opposition participation in proxy contests is remarkably low” (ibid., 420.).

<sup>41</sup> Joseph A. Livingston, *The American Stockholder*, vol. New, rev (New York: Collier Books, 1963). 33.

<sup>42</sup> Ibid., 57, 210. The distinguishing factor between institutional investors and individual blockholders for Livingston appears to be the fact that institutional investors were, largely, not active in the affairs of the portfolio companies (i.e., they did not assume an activist role). Rather, institutional investors preferred to reduce their interactions with the companies to less public and more private modes (e.g., direct channels of communication as opposed to engagement in proxy contests). This, Livingston noted, is the institutional investors’ attitude primarily “for their

Livingston's remarks deserve at least two comments. First, they raise the question: to whom do institutional investors owe responsibility? Manne noted that attaching institutional investors with the guardianship position for the sake of all shareholders of a public firm might result in causing institutional investors to breach their primary duty. A duty owed to their named beneficiaries.<sup>44</sup> Second, in the absence of a large shareholder capable of exerting influence on the corporation's management, market mechanisms such as takeovers act as a restoration process.<sup>45</sup>

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own self-protection and guidance, not for other stockholders in general" (ibid., 140). While this may be the result of the individual funds' investment policy (see, e.g., Wharton School, United States. Securities and Exchange Commission, and United States. Congress. House. Committee on Interstate and Foreign Commerce, *Study of Mutual Funds*: 26), it is different from the methods of individual blockholders who do not seem to be anxious about engaging in the proxy contest.

<sup>43</sup> Livingston, *American Stockholder*, New, rev: 216.

<sup>44</sup> Henry G. Manne, "The "Higher Criticism" of the Modern Corporation," *Columbia Law Review* 62, no. 3 (1962): 420. In 2003, the SEC adopted a new rule (Proxy Voting by Investment Advisers, 17 CFR Part 275 [Release No. IA-2106; File No. S7-38-02]) that, inter alia, imposes a fiduciary duty on fund advisers who vote a fund's proxy to do so in the best interests of the client. In its reasons for the adoption of the rule, the SEC notes that until this release "[t]he federal securities laws do not specifically address how an adviser must exercise its proxy voting authority for its clients."

<sup>45</sup> As for the participation of mutual funds in merger activity involving portfolio companies, the Wharton Report found that large funds (i.e., those having assets of \$150 million or more) were, on occasion, actively involved in consultation with their companies on these matters. In "all reported cases of investment company initiatives on mergers found them urging portfolio companies to accept particular proposals or to explore the possibilities of mergers." Wharton School, United States. Securities and Exchange Commission, and United States. Congress. House. Committee on Interstate and Foreign Commerce, *Study of Mutual Funds*: 427. It also reported one instance of five funds making a joint recommendation. This is an indication that funds can act in concert to influence management decisions in a manner similar to a blockholder (i.e., one that is not an institutional investors).



Restoration in this context refers to the monitoring and displacement of managers by the shareholders. This was particularly evident in the majority of firms (i.e., firms that display the blockholder mode of ownership), where takeovers and proxy contests play the role of a corrective mechanism. As Vagts commented in 1966:

It is less recognized that there is a class of corporations ... a class still fairly closely resembling the model for which most corporation laws were intended. ... Internally they have a number of stockholders too great to permit their shareholders to run the firm themselves but not too great to prevent them from keeping in touch with its activities and rallying to correct management when it strays too far from their view of things. It is in this stratum of firms ... that the bulk of proxy contests take place and that insurgents have some hope of success. A shift in corporate legal structure appropriate enough for the corporate giant might be burdensome or even disastrous for the intermediate concern as well as for the midget.<sup>46</sup>

Restoration, however, may also have another reinforcing meaning. As long as the firm's ownership is not sufficiently diffused to render shareholder action impossible, shareholders (either in the form of a single blockholder or a group of investors rising to the levels of a blockholder) may serve as a check on management. In the absence of such a blockholder, market actors (whether individuals or institutional), provided they deem the firm to be one which is worth investing in, will acquire or increase their holdings in the firm to levels sufficient to effect the requisite changes in the firm. Thus, as Eisenberg noted, "[e]ven when all the stock in a corporation is so atomistically dispersed that existing shareholders cannot effectively use their votes, the vote is nevertheless something of value because of the potentiality that the

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<sup>46</sup> Detlev F. Vagts, "Reforming the "Modern" Corporation: Perspectives from the German," *Harvard Law Review* 80, no. 1 (1966): 32.

shareholding pattern will change; because ... of the 'interplay of share voting and share transferability.'"<sup>47</sup>

### III. STAGE II: TOWARDS THE MOBM

The period covering the early 1960s to the present evidenced much activity and development, both in the markets and the literature. The discussion in this section will touch upon certain observations to the extent necessary to gain an appreciation of the re-concentration of equity in the hands of institutional investors (i.e., an appreciation of the flow of equity) during this period.

#### A. A COMMENT ON THE WORKING HYPOTHESIS IN THE LITERATURE

During this period, blockholders continued to be a feature of the American equity markets.<sup>48</sup> The working hypothesis in the scholarship, however, was, and still is, the opposite. Bebchuk and Roe provide a representative illustration of the working hypothesis in the literature vis-à-vis

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<sup>47</sup> Melvin Aron Eisenberg, "The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking," *California Law Review* 57, no. 1 (1969).

<sup>48</sup> Ronald C. Anderson and David M. Reeb, "Founding-Family Ownership and Firm Performance: Evidence from the S&P 500," *The Journal of Finance* 58, no. 3 (2003); Eisenberg, "Legal Roles of Shareholders."; Clifford G. Holderness, "The Myth of Diffuse Ownership in the United States," *Review of Financial Studies* 22, no. 4 (2009); Clifford G. Holderness and Dennis P. Sheehan, "The Role of Majority Shareholders in Publicly Held Corporations," *Journal of Financial Economics* 20(1988); Rafael La Porta et al., "Law and Finance," *The Journal of Political Economy* 106, no. 6 (1998); Andrei Shleifer and Robert W. Vishny, "Large Shareholders and Corporate Control," *Journal of Political Economy* 94, no. 3 (1986); ———, "A Survey of Corporate Governance," *Journal of Finance* 52, no. 2 (1997); Vagts, "Reforming the "Modern" Corporation."

ownership structures in the USA: "At present, publicly traded companies in the United States and the United Kingdom commonly have dispersed ownership."<sup>49</sup>

One reason for this may be rooted in the continued echoing of Berle and Means' irrelevance argument vis-à-vis non-large firms. The following comment by Clark serves as an illustration: "The large public corporations, though relatively less numerous, do a disproportionately huge part of corporate business."<sup>50</sup> Adopting such an approach to policy-making in the sphere of corporate governance may have adverse consequences. As Vagts observed in the passage quoted above, "[a] shift in corporate legal structure appropriate enough for the corporate giant might be burdensome or even disastrous for the intermediate concern as well as for the midget." This is particularly so where small and mid-sized public firms represent the majority of listed firms on the various stock exchanges in the USA. Another reason may be the persistence of the view of institutional investors as being a vehicle for the facilitation of the diffusion of ownership in the public firm.

Despite the apparent inconsistency between the evidence at the level of the equity markets vis-à-vis block holdings, on the one hand, and the scholarship's view of such evidence, on the other, it is useful to examine certain developments in the equity markets during this period in relation to equity ownership in the USA.

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<sup>49</sup> Bebchuk and Roe, "Path Dependence," 133. Some refer to this as the "Berle-Means orthodoxy" see e.g., Brian R. Cheffins and Steven A. Bank, "Is Berle and Means Really a Myth?," *Business History Review* 83, no. 3 (2009)..

<sup>50</sup> Robert Charles Clark, "Review: The Four Stages of Capitalism: Reflections on Investment Management Treatises; The Regulation of Money Managers; The Law of Investment Management," *Harvard Law Review* 94, no. 3 (1981): 563. See also Cheffins and Bank, "Is Berle a Myth."

More specifically, I propose we examine the growth in the ownership of corporate America by institutional investors and corporate control activity (where the discussion on the latter is restricted primarily to developments since the 1980s). While these areas are discussed extensively in the literature, I focus on them for two primary reasons. First, the growth of institutional investors during this period constitutes a re-concentration of ownership in the public firm. Second, corporate control activity during this period serves to illustrate this mechanism's role in restoring ownership levels in public firms to blockholder levels (i.e., those in the range of 5–50%). Viewed in this way, transactions such as leveraged buyouts (LBO) and private equity (PE) can be seen as extreme reactions by the market in cases where ownership in the public firm becomes too diffused for the purposes of enabling the public firm to engage in shareholder value maximizing activities.<sup>51</sup> Both developments represent the market's gravitation towards the MOBM, which, to recall our definition, is a hybrid model of public corporate ownership that displays block holdings accompanied by market mechanisms (such as takeovers).

## **B. INSTITUTIONAL INVESTORS AS RE-CONCENTRATING OWNERSHIP**

According to a 2007 report by the Bank for International Settlements, institutional investors are “becoming increasingly important in global finance.”<sup>52</sup> For example, institutional investors and hedge funds account for a 70% share of the US and the European syndicated leveraged loan

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<sup>51</sup> One objection to this view of LBOs, PEs or takeovers in general, as restoring ownership levels to some ownership equilibrium for the purposes of achieving and maintaining any such equilibrium may be found in the assertion that such a suggestion may be overlooking a whole body of literature on the motives that drive and give rise to such transactions. One should remember, however, that the focus of this article is on the flows of equity.

<sup>52</sup> BIS Committee on the Global Financial System, "Institutional Investors, Global Savings and Asset Allocation," in *CGFS Publications No 27* (Bank for International Settlements, 2007).

market,<sup>53</sup> replacing banks as the main investors in the leveraged finance market.<sup>54</sup> Their size, however, is not confined to the debt markets. As we shall see, institutional investors have become major investors in the equity of corporate America.

### 1. Institutionalization of the capital markets

The rise to prominence by institutional investors during this period signifies the continued transfer of share ownership from individual investors to institutions that hold the shares on behalf of a larger group of investors/savers. Manuel Cohen, former Chairman of the SEC, called the process the ‘institutionalization’ of the American securities markets.<sup>55</sup> As Cohen explained, ‘[t]his means, simply, that more and more of the outstanding equity is being acquired by

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<sup>53</sup> BIS Monetary and Economic Department, "Financial System and Macroeconomic Resilience," in *BIS Papers No. 41* (for International Settlements, 2008).

<sup>54</sup> BIS Committee on the Global Financial System, "Private Equity and Leveraged Finance Markets," in *CGFS Papers No. 30* (Bank for International Settlements, 2008).

<sup>55</sup> Manuel F. Cohen, "An Address by Manuel F. Cohen, Chairman, Securities and Exchange Commission, before the American Bankers Association" (paper presented at the Mid-Winter Trust Conference, February 11 1969). The reduced dominance of the individual investor since World War II and the increased dominance of the institutional investor since that time, and hence the institutionalization of the US capital markets, was also stimulated by Congress "through various income tax provisions, as it did just recently with the Employee Retirement Income Security Act of 1974 ('ERISA')," Ray Jr. Garrett, "Future Securities Markets – Reform, Not Revolution, An Address by Ray Garrett, Jr, Chairman, Securities Commission," in *North American Securities Administrators Conference, 58th Annual Conference* (MacKinac Island, Michigan: US Securities and Exchange Commission, 1975), 5.. ERISA, inter alia, sought to regulate the conduct of trustees and their investment decisions in the area of pension funds by introducing a prudent person rule.

financial intermediaries and that more and more of the activity in our markets is a reflection of quickening activity by those institutions and those who would imitate them.”<sup>56</sup>

The phenomenal growth of institutional investors resulted in the SEC commissioning a new study for the purpose of understanding its implications for the securities markets.<sup>57</sup> While the SEC was attempting to assess the policy implications of the institutionalization of the securities markets, others were calling on institutional investors to cause their portfolio companies to adopt good social behavior.<sup>58</sup> Thus, institutional investors were being pushed in the direction of providing stronger monitoring of portfolio firms. Stated in the alternative, institutional investors, as in the case of Livingstone, were being asked to assume the role of a blockholder (i.e., the non-institutional investor).<sup>59</sup>

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<sup>56</sup> Cohen, "An Address by Manuel F. Cohen, Chairman, Securities and Exchange Commission, before the American Bankers Association," 3.

<sup>57</sup> Ibid. Reference here is to a 1971 study by the SEC titled *Institutional Investor Study Report* SEC, "Institutional Investor Study Report," (Washington D.C.: Securities and Exchange Commission,, 1971)..

<sup>58</sup> See, e.g., W.C.N, "The Institutional Investor and Social Responsibility," *Financial Analysts Journal* 27, no. 5 (1971).

<sup>59</sup> While such encouragement of institutional investors to persuade their portfolio firms to become improved corporate social performers, particularly in light of their sizeable holdings, sounds promising, evidence may be to the contrary. For example, a recent study of 1,306 shareholder proposals in 281 firms over a seven year period, from 1992 to 1998, suggests that, rather than encourage firms to improve their corporate social responsibility, activism by shareholders may result in diversion of resources from such activities into ones that can be used by managers for the purposes of resisting external pressures. Parthiban David, Matt Bloom, and Amy J. Hillman, "Investor Activism, Managerial Responsiveness, and Corporate Social Performance," *Strategic Management Journal* 28, no. 1 (2007)..

a) *Two perspectives on institutional investors*

According to Davies, the increase in institutional investors' participation in the capital markets constitutes "a partial re-concentration of shareholdings ... into the hands of 'institutional' shareholders, especially pension funds and insurance companies."<sup>60</sup> He adds that the conception of the firm as diffusely owned in the Berle and Means sense "has been altered by the concentration over recent decades of shares in public companies in the hands of institutional investors."<sup>61</sup>

This view stands in contrast to the views expressed in the 1920s that held institutional ownership as a method of dispersing the ownership of the public firm.<sup>62</sup> The view that shareholdings by institutional investors are part of the dispersion of ownership in the public firm is not confined to the early stages of the capital markets. For example, albeit in the context of the UK but nonetheless relevant at this point, Cheffins and Bank claim that tax rules and rates in the UK induced the reduction of ownership stakes by blockholders, while at the same time fuelling the growth of institutional investors.<sup>63</sup> In reality, however, the role of taxation in the UK was the transfer of share ownership from one blockholder (e.g., the family investor) to smaller blockholders (i.e., the institutional investors).

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<sup>60</sup> Davies, *Gower & Davies*, 7th: 337.

<sup>61</sup> *Ibid.*, 338. It is worth noting that although Davies is speaking in the context of the UK, the same can be said in the context of institutional investors in the USA.

<sup>62</sup> See text to notes 14-17.

<sup>63</sup> Brian R. Cheffins and Steven A. Bank, "Corporate Ownership and Control in the UK: The Tax Dimension," *Modern Law Review* 70, no. 5 (2007). This is a similar process to the one in the US, as noted earlier in the discussion vis-à-vis ERISA, where, in order to facilitate the institutionalization of the US capital markets or the new realities created by the institutionalization of the markets, Congress introduced such measures as ERISA.

The following observation by Davies allows us to align the two perspectives on institutional investors' effect on firm ownership for the purposes of gaining a clearer picture of the process,

All this may not be very apparent to the individuals ... who simply wish to provide themselves with an income when they cease to work. For example, all they may have done is join an occupational pension scheme ... or personal pension plan ... However ... the effect of channelling savings into the securities markets in this way over a number of decades has been to produce a remarkable concentration of shareholdings in the market as a whole in the hands of institutional investors.<sup>64</sup>

Thus, when seeking to determine the nature of ownership (i.e., diffused vs. block holdings) in the process of analysis, one should be mindful of the quantum of the shareholdings or the size of the investor's holdings in proportion to the individual firm's outstanding stock. If we view the holder of shares in a firm *qua* shareholder, irrespective of whether it is an institutional investor or an individual, once its shareholdings cross a certain threshold it becomes a blockholder. This threshold may be lower for very large companies, at least for the purposes of influencing management.

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<sup>64</sup> Paul L. Davies, *Introduction to Company Law*, Clarendon law series (Oxford; New York: Oxford University Press, 2002). 141-42.



**b) Continued growth in institutional participation in the capital markets**

During the 1970s, institutional investors continued their growth and increased their equity positions in the American securities markets.<sup>65</sup> In addition to increasing their equity holdings in publicly held firms, generally, all institutional investors appear to have concentrated their holdings in relatively few large firms.<sup>66</sup> Another interesting observation during this period is that direct individual share ownership continued to decline during this time.<sup>67</sup> Hence, the markets were witnessing the gradual and continued transformation from individual blockholders to financial blockholders. This transformation continued well into the 1980s and to the present day.

According to The 2008 Institutional Investment Report,<sup>68</sup> released by The Conference Board, total institutional investor assets in the US increased from \$2.7 trillion in 1980 to \$27.1

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<sup>65</sup> Donald E. Farrar and Lance Girton, "Institutional Investors and Concentration of Financial Power: Berle and Means Revisited," *Journal of Finance* 36, no. 2, Papers and Proceedings of the Thirty Ninth Annual Meeting American Finance Association, Denver, September 5-7, 1980 (1981).

<sup>66</sup> Ibid., 373-75. This does not appear to be a feature that is unique to American institutional investors. For example, Ferreira and Matos in a study of institutional investors from 27 countries report that these investors, irrespective of geographic origin, prefer to invest in large firms from countries with strong disclosure standards. In addition, they find that American institutional investors show a preference towards value, as opposed to growth, stocks. Miguel A. Ferreira and Pedro Matos, "The Colors of Investors' Money: The Role of Institutional Investors Around the World," *Journal of Financial Economics* 88, no. 3 (2008)..

<sup>67</sup> Farrar & Girton noted "[d]irect stockholdings by individuals remained more or less constant in absolute value ... while their relative share of total outstanding declined," Farrar and Girton, "Institutional Investors," 372..

<sup>68</sup> Carolyn Kay Brancato and Stephan Rabimov, *The 2008 Institutional Investment Report: Trends in Institutional Investor Assets and Equity Ownership of U.S. Corporations* (The Conference Board, 2008).

trillion in 2006.<sup>69</sup> Total institutional holdings have increased from \$8.7 billion in 1950 (representing 6.1% of total equity markets) to \$12.9 trillion in 2006 (representing 66.3% of total equity markets).<sup>70</sup> Figure 2-1 shows growth of institutional investors relative to the market and compares the market value of total outstanding equity in the market with the market value of total institutional equity holdings between 1950 and 2006. The levels of ownership concentration in America's 1,000 largest firms are more revealing. Table 2-1 compares institutional investor concentration of ownership in the top 1,000 US firms in 1987 and 2007 reveals that institutional investors have increased their holdings in the largest 1,000 US firms to 76.4% in 2007 (compared with 46.6% in 1987).

The report also shows that America's top 25 corporations (ranked by market capitalization as of 31 December 2007) had a total institutional investor average holding ranging from a low of 52.9% in Exxon Mobil to a high of 85.4% in AIG.<sup>71</sup> Of these 25 firms, 15 had at least one blockholder (i.e., an investor owning 5% or more of the outstanding shares),<sup>72</sup> and in six firms the largest investor held near blockholder levels (i.e., in the 4–5% range). Figure 2-2 shows concentration of institutional investor holdings in the largest 25 corporations, depicting

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<sup>69</sup> Ibid., 4.

<sup>70</sup> Ibid., 5. The 66.3% of institutional investor ownership can be broken down by category of institutional investors. Here we see that pension funds account for 28.5% of the total US equity market, investment companies account for 26.3% of these markets, insurance companies account for 8.4% of these markets, and banks and trust companies and others account for a total of 3.1% (ibid., 22.).

<sup>71</sup> Ibid., 6.

<sup>72</sup> These include AT&T, which Berle and Means used as their example of a dispersed giant corporation. Berle and Means, *Modern Corporation*: 4.

the institutional investor holdings in America's largest 25 firms (in total and by the largest 10, 20 and 50 institutions).

Moreover, the report observes that “[i]nstitutional investors in general (and state and local pension funds in particular) have continued their long-term trend towards more aggressive equity investing while reducing their bond holdings.”<sup>73</sup> This is significant since, “not only are the ‘activist’ state and local investors increasing their relative share ... but they are also devoting a relatively larger share of their assets to equities, which is used as a basis for proxy voting to further their corporate governance agendas.”<sup>74</sup>

Hence, activist institutional investors are using legal tools, such as shareholder rights, to exert their influence on public firms.<sup>75</sup> Despite this, some argue that collaboration or coalition

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<sup>73</sup> Brancato and Rabimov, *2008 Report*: 6.

<sup>74</sup> Ibid. Equity ownership is not the only tool institutional investors can use to promote their corporate governance agendas in corporations. In a relatively recent development, some institutional investors purchase a troubled company's debt (i.e., investment in distressed debt) in order “to influence corporate matters by exercising or threatening to exercise its contractual and statutory rights as a debtholder,” Michelle M. Harner, “The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing,” *Fordham Law Review* 77(2008): 705. Harner found that “some institutional investors are strategically using distressed debt investments to influence corporate governance and, in some cases acquire a company” (ibid., 709.).

<sup>75</sup> See also Marens Richard Marens, “Going to War With the Army You Have: Labor's Shareholder Activism in an Era of Financial Hegemony,” *Business & Society* 47, no. 3 (2008). Marens observed at 319-320, “[u]nion activists have exploited the rights of shareholders to find ways to confront recalcitrant or otherwise hostile management teams ... Labor's use of resolution broadened during the course of the 1990s and increasingly focused on governance issues ... labor activists became the new leaders of shareholder governance activism.” The use of shareholder rights is not, however, universal among all institutional investors. See, e.g., Taub Jennifer S. Taub, “Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights,” *Journal of*

forming between institutional investors for the purposes of influencing corporate managers is difficult for both legal and non-legal reasons.<sup>76</sup> For example, Bainbridge argues that institutional investors may be as apathetic as individual investors vis-à-vis the monitoring of portfolio firms as the costs associated with monitoring may outweigh the benefits.<sup>77</sup> In addition, Bainbridge argues that, due to self-interest and competition for investor capital, institutional investors may not be inclined to collaborate with other institutional investors in order to influence managements and boards of their portfolio firms.<sup>78</sup> These two hurdles, however, can be overcome<sup>79</sup> and activity at the market place suggests that they actually are.<sup>80</sup> One final hurdle

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*Corporation Law* 34, no. 3 (2009). Taub, observed (at 844), "... when it comes to pushing portfolio companies for shareholder governance reforms, mainstream [mutual] fund families remain passive. ... data shows that mainstream fund Advisers overwhelmingly cast votes in favor of management and against shareholder advisory resolution on matters including corporate governance."

<sup>76</sup> But see Marens Marens, "Going to War." Marens noted (at 322) that activist institutional investors have orchestrated successful coalitions, though such an exercise is "a more logistically difficult accomplishment than triggering large 'yes' votes on governance issues."

<sup>77</sup> Stephen M. Bainbridge, "Shareholder Activism in the Obama Era," *UCLA School of Law, Law-Econ Research Paper No. 09-14*(2009), <http://ssrn.com/paper=1437791>. But see Marens, "Going to War." Marens observed (at 329) that in recent years "there are two pieces of substantial evidence that point to coordination ... One is the submission of very similar or even identical resolutions at different companies by pension funds of different unions. ... some of this coordination seems to include at least a few public pension funds."

<sup>78</sup> Bainbridge, "Shareholder Activism in the Obama Era". 13-15.

<sup>79</sup> See, e.g., Danyelle Guyatt, "Pension Collaboration: Strength in Numbers," *Rotman International Journal of Pension Management* 1, no. 1 (2008). Guyatt suggested that collaboration among pension funds has emerged in response to investment and capital markets dysfunctions, and suggests a framework for collaboration.

<sup>80</sup> See, e.g., Marens, "Going to War." Marens detailed the rise of institutional investor activism, in general, and of activist labor investors, in particular, over the past number of decades in the US using the tools of shareholder.

identified by Bainbridge relates to legal rules that impede shareholder communications.<sup>81</sup> This hurdle, however, has been eroding over a number of years. As Strine recently observed, “the power of stockholders to influence the composition of corporate boards and the direction of corporate strategy has been markedly enhanced” over the last 30 years.<sup>82</sup>

c) *Divergence between literature and markets*

The above discussion highlights the existence of a divergence between the working hypothesis in the literature (that American firms are dispersed) and reality (that American firms are characterized by the MOBM). The persistence of the working hypothesis (and the adherence to the Berle–Means orthodoxy) is a curiosity that appears to have its roots in a location other than the markets.

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<sup>81</sup> Bainbridge, "Shareholder Activism in the Obama Era". 13.

<sup>82</sup> Leo E. Jr. Strine, "Risk-Taking by Boards and the Financial Crisis," *Directorship*, <http://www.directorship.com/strine-risk/>. See also Sargent and Honabach, "Proxy Regulation and the Corporation Governance Debate, § 1:1 Introduction." Sargent and Honabach observed, inter alia, that since the late 1980s, institutional investors, under the leadership of such actors as the California Public Employees Retirement System (CalPERS), sought to amend the proxy rules in order to achieve three objectives: (i) to protect the market for corporate control by removing anti-takeover measures adopted by managements and boards; (ii) to increase shareholder input into corporate decision-making; and (iii) to influence the election of corporate boards. According to Sargent and Honabach, institutional investors have been successful in their efforts to influence the SEC and US Congress in amending the proxy rules to facilitate the first of two of these goals. The third objective is currently in the proposal stages *Facilitating Shareholder Director Nominations*, 17 CFR Parts 200, 232, 240, 249 and 274 [Release Nos. 33-9046, 34-60089; IC-28765; File No. S7-10-09] [the "Proposal"].

This disparity appears to signify the gap between the scholarship's perceptions of what the hypothetical markets should look like and what the markets actually exhibit.<sup>83</sup> As Cheffins noted, "interested observers implicitly agreed that the 'Berle–Means corporation' would be the dominant paradigm in a market economy."<sup>84</sup> Jacoby provides a complementary explanation. He proposes that agency theory was internalized by various actors (e.g., academics, courts, and institutional investors) during the 1970s and the era of hostile takeovers as means of empowering shareholders and circumventing boards of directors.<sup>85</sup> This ushers us to the examination of the role of institutional investors in control transactions.

## 2. Market for Corporate Control and Institutional Blockholders

Above it was noted that since the early 1960s institutional investors increased their equity positions in public corporations and at least some became active as shareholders in the affairs of their portfolio firms, thereby becoming more active in monitoring the management of portfolio firms. Attention now shifts to another important role played by institutional investors: namely, their role in the market for corporate control. We do this because corporate control transactions, by reducing tensions between the firm's management and its shareholders through posing an ongoing threat of replacement to the management of poorly performing firms, perform an

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<sup>83</sup> This should not be taken as an argument for or against the idea of corporate democracy. Rather, it is a comment vis-à-vis the pursuit of some unattainable theoretical construct that appears to be imposed on markets that do not display (in exact terms) its assumptions (i.e., dispersed ownership). This may also explain the lack of a unified theory of the firm.

<sup>84</sup> Cheffins, "Does Law Matter."

<sup>85</sup> Sanford M. Jacoby, "Finance and Labor: Perspectives on Risk, Inequality, and Democracy," *Comparative Labor Law and Policy Journal* 30, no. Journal Article (2008): 32-33.

important governance role.<sup>86</sup> Takeovers, including proxy contests, achieve this, inter alia, by concentrating ownership and/or voting power, at least temporarily, when needed.<sup>87</sup>

Institutional investors participate in control transactions in several ways. For example, management may consult with the institutional investors over whether to participate in the sale or acquisition of a business.<sup>88</sup> Second, institutional investors may acquire the portfolio company<sup>89</sup> or use their voting power and proxy system to either prevent or promote an acquisition or sale. Third, some have argued that because of the size of institutional investors' holdings, "[h]istorically, their value has been greatest to takeover bidders who may conveniently purchase a large number of shares at inflated prices in order to gain control of management."<sup>90</sup> Let us examine institutional investors' role since the 1980s in the context of the last statement.

Starting in the 1980s, institutional investors became an important player in the LBO market. In a study of the merger activity in the USA during the 1980s and 1990s, Holstrom and Kaplan observed that starting in the 1980s, the "capital markets grew more powerful with

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<sup>86</sup> Manne, "Market for Corporate Control."

<sup>87</sup> Marco Becht, Patrick Bolton, and Ailsa A. Röell, "Corporate Governance and Control (October 2002).", *ECGI - Finance Working Paper No. 02/2002*, no. Journal, Electronic (2002), <http://ssrn.com/paper=343461>.

<sup>88</sup> See e.g., note 45 and accompanying text. In instances where the institutional investor has cross-shareholdings in both the target and the acquiring firm, the institutional investor can limit losses associated typically with the holdings of the acquirer firm. This may lead to a conflict of interest between the cross-holding institutional investors and other, non-cross-holding, shareholders involved in the transaction. Gregor Matvos and Michael Ostrovsky, "Cross-ownership, Returns, and Voting in Mergers," *Journal of Financial Economics* 89, no. 3 (2008)..

<sup>89</sup> See, e.g., notes 37 and 75.

<sup>90</sup> Brent A. Olson, "Management and Control of the Publicly Traded Corporation II. Shareholders' Roles," in *Publicly Traded Corporations: Governance & Regulation* (Westlaw, 2008).

increased institutional investments. The potential for improved corporate performance paired with empowered investors gave birth to takeovers, junk bonds and leveraged buyouts.”<sup>91</sup>

Regarding the role of institutional investors in takeover activity, they noted,

[o]ne of the important effects of greater institutional ownership was on takeovers. Fund managers were more interested in squeezing out higher returns ... than individual investors. Institutional investors were often the key sellers of large blocks of shares in takeovers. This made takeovers easier. Institutional investors also supported takeovers by being large investors in the buyout funds and in the market for high-yield bonds.<sup>92</sup>

On the role of institutional investors in takeover activity during the 1990s, Holstrom and Kaplan note that institutional investors (along with managers and boards) appear to have advocated lucrative stock option plans, which allowed managers to “share in the market returns from restructured companies.”<sup>93</sup> and thereby facilitate takeover activity “on amicable terms.”<sup>94</sup>

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<sup>91</sup> Bengt Holmstrom and Steven N. Kaplan, "Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s," *Journal of Economic Perspectives* 15, no. 2 (2001): 122.

<sup>92</sup> *Ibid.*, 132.

<sup>93</sup> *Ibid.*, 122. The preoccupation with the alignment of managerial interest with shareholder interest via compensation plans is based on the premise of the modern corporation as dispersed and is related to agency theory. Thomas, in developing a ‘Bargaining Power Theory’ to explain CEO pay differentials between US and non-US executives, claims (i) that institutional investors, with the aid of others, shoulder the responsibility for US-style compensation plans; and (ii) that such compensation plans did not gain momentum in markets typically associated with blockholder ownership. Randall S. Thomas, "Explaining the International CEO Pay Gap: Board Capture or Market Driven," *Vanderbilt Law Review* 57, no. 4 (2004). This lends itself to the assertion that the quality of monitoring by a blockholder (or a shareholder with a sizable share in a company) varies with the particular blockholder’s investment horizon. See also Strine, arguing that the risks, and the rewards derived therefrom, taken



Institutional investors' participation in corporate control transactions, during the 1980s and 1990s, was not limited to the capital markets. Their size and growing importance allowed them to influence governmental bodies, such as the SEC, in amending the law when it prevented their fuller participation in the marketplace. Specifically to the takeover process, they were instrumental in changing the proxy rules in 1992 in order to reduce the costs associated with monitoring corporate managers by making it easier for them to mount proxy challenges.<sup>95</sup>

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by corporate managers leading to the recent economic crisis are related to compensation programs that encouraged managers to generate short-term profits in order to please institutional shareholders. Strine, "Risk-Taking".

<sup>94</sup> Holmstrom and Kaplan, "Corporate Governance," 122. In using the term "amicable," Holstrom and Kaplan *ibid.* are presumably trying to distinguish the environment of takeover activity in the 1990s from that in the previous decade, which was described as having a hostile or non-friendly flavor see, e.g., *ibid.*; Pound, "Raiders.". Holstrom and Kaplan's description of the role of institutional investors in the takeover process during the 1980s and 1990s being one based on short-term investment horizons and transaction promoting due to sizeable holdings can be contrasted with earlier views such as those proposed by Bernard S. Black, "Institutional Investors and Corporate Governance: The Case for Institutional Voice," *Journal of Applied Corporate Finance* 5, no. 3 (1992).. According to Black, institutional investors' role in the takeover process can be (or should be) one of monitoring and discerning good from bad acquisitions. Thereby reducing the number of opportunistic, value reducing, transactions.

<sup>95</sup> Bloomenthal and Wolff noted the role of CalPERS and other institutional investors in causing the SEC to amend the proxy rules (referring to Regulation of Communication Among Shareholders, Release No. 19031, Release No. 31326, Release No. 34-31326, Release No. IC - 19031, 52 S.E.C. Docket 2028, 1992 WL 301258 (S.E.C. Release No.)). Harold S. Bloomenthal and Samuel Wolff, "§ 24:1," in *Securities and Federal Corporate Law (2d ed.)* (2011). It is interesting to note that in their arguments for amending the proxy rules, CalPERS argued the significance of long-term investment horizon of institutional investors. This is of note given that it has been argued that "[i]nstitutional investors have never been the paragons of long-term investing that some claim to be." Jacoby, "Finance and Labor," 24.. See also Holstrom and Kaplan Holmstrom and Kaplan, "Corporate Governance."

This leads us to the most recent wave of takeover activity involving PE. The PE market has displayed tremendous growth over the last number of years.<sup>96</sup> Data compiled by the World Economic Forum shows that “the total value of firms ... acquired in leveraged buyouts is estimated to be \$3.6 trillion from 1970 to 2007, of which \$2.7 trillion worth of transactions occurred between 2001 and 2007.”<sup>97</sup> Institutional investors, as in the case of the LBO wave of the 1980s, contributed to the mushrooming of the PE wave. Some institutional investors have done so directly by attempting to acquire underperforming public firms.<sup>98</sup> Others have participated in the PE market via investments in hedge funds and PE funds.<sup>99</sup>

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<sup>96</sup> For factors that explain the growth in PE activity see, e.g., Steve Kaplan, "Private Equity: Past, Present, and Future," *Journal of Applied Corporate Finance* 19, no. 3 (2007)..

<sup>97</sup> Josh Lerner and Anuradha Gurung, eds., *Globalization of Alternative Investments Working Papers Volume 1: The Global Economic Impact of Private Equity Report 2008* (New York, NY: World Economic Forum USA Inc., 2008). The report also reveals that while the LBO wave of the 1980s was largely an American phenomenon, the recent PE wave was a global one – signifying an embrace of the market for corporate control mechanism by non-US actors.

<sup>98</sup> See, e.g., the failed proposed acquisition of BCE, the parent company of Bell Canada, for US \$43.3 billion by a consortium consisting of Teachers Private Capital (the private investment arm of the Ontario Teachers' Pension Plan), Madison Dearborn Partners LLC, and Merrill Lynch Global Private Equity.

<sup>99</sup> See, e.g., William W. Bratton, "Hedge Funds and Governance Targets," *Georgetown Law and Economics Research Paper No. 928689*; *ECGI - Law Working Paper No. 80/2007*, no. Journal Article (2007), <http://ssrn.com/paper=928689>; ———, "Private Equity's Three Lessons for Agency Theory," *European Business Organization Law Review* 9, no. 4 (2008); Steven N. Kaplan and Antoinette Schoar, "Private Equity Performance: Returns, Persistence, and Capital Flows," *Journal of Finance* 60, no. 4 (2005).

Jensen has argued that PE offers or introduces a new model for corporate governance.<sup>100</sup> This is because the PE model resolves one weakness associated with the large public corporation, namely that of agency costs associated with the separation of ownership from control. The new governance model introduced by PE, according to Jensen, is a result of the similarity between the PE model and the venture capital model. Both models are said to introduce economic efficiency into the corporation in the form of improved corporate governance and management oversight.<sup>101</sup> Elson qualifies Jensen's argument by explaining that the lesson from the recent PE activity is that governance can be improved through the introduction of a blockholder into the boards of public corporations.<sup>102</sup>

#### **IV. OBSERVATIONS VIS-À-VIS THE TREND TOWARDS THE MARKET ORIENTED BLOCKHOLDER MODEL**

The above discussion reveals an evolutionary trend in the ownership of public firms in the US towards the MOBM. The trend exhibits three related observations: (i) the existence of a market-driven self-regulatory mechanism at the level of the capital markets that tended to concentrate ownership in the hands of blockholders (in institutional investors in particular), (ii) this self-

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<sup>100</sup> Jensen, "Eclipse."; ———, "The Economic Case for Private Equity (and Some Concerns) -- pdf of Keynote Slides," (2007), <http://ssrn.com/paper=963530>.

<sup>101</sup> For a comparison between the LBO and venture capital models see, e.g., Joel M. Stern, G. Bennett Stewart, III, and Donald H. Chew, "The EVA Financial Management System," *Journal of Applied Corporate Finance* 8, no. 2 (1995).. But see Bratton, "Private Equity's.", noting (at 533) that PE model "appears to work within its own limited duration framework."

<sup>102</sup> Charles Elson, "The State of U.S. Corporate Governance: An Interview with Chales Elson," *Journal of Applied Corporate Finance* 19, no. 1 (2007): 78.

regulatory process was facilitated by information flows, and (iii) this self-regulatory process went undetected due to distortions in the corporate governance literature that relate to biases (a) inherited from Berle and Means and (b) resulting from the treatment of institutional investors as vehicles for the facilitation of ownership diffusion. Next, I briefly discuss each.

#### **A. MARKET DRIVEN SELF-REGULATORY TREND TOWARDS THE MOBM**

The observable trend is one that moved from concentrated ownership to “dispersed” ownership and then to the blockholder mode of ownership. When ownership was “dispersed”, dispersion was limited (i) to a portion of the equity markets (i.e., large firms) and, to an extent, (ii) in duration (i.e., until the emergence of institutional investors as significant investors starting in the post-World War II era). Put differently, we see that the nature of the blockholder has changed over the years, generally speaking, from one type of investor/blockholder (i.e., the individual investor) to another (i.e., the institutional investor). The differences between the two became one of degree of concentration of ownership and one of perception by the public. Both types of blockholders introduce into the firms in which they are present the valuable function of monitoring management (as well as other, potentially less desirable, outcomes<sup>103</sup>).

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<sup>103</sup> Depending on the size of the firm and extent of institutional holdings there is, for example, the potential for institutional investors’ to influence the election of directors, investment as well as financing decisions of the firm. There is also the potential for board dominance and the compromise of board independence (which is generally associated with non-institutional blockholders). Moreover, institutional investors, as do individual blockholders, play a significant role in the corporate control environment. Finally, there is the possibility of tensions between the blockholder (both individual and institutional investor) and other shareholder. One should approach the last observation with caution, for a confusion of terminology may have interesting implications. For example, Enriques and Volpin observed that “concentrated ownership can create conditions for a *new agency problem*, because the

If we view the above observations collectively, then, we see that market forces at the level of the US equity markets have been combining the two extreme poles of ownership structures (i.e., diffused ownership, on the one hand, and concentrated, on the other) into a hybrid structure that affords both liquidity in the capital markets<sup>104</sup> and increased monitoring by blockholders.<sup>105</sup> Unique to this process in the US is the fact that such a coupling of ownership systems works harmoniously with market mechanisms such as corporate control transactions.

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interests of controlling and minority shareholders are not aligned” [emphasis added]. Luca Enriques and Paolo Volpin, "Corporate Governance Reforms in Continental Europe," *Journal of Economic Perspectives* 21, no. 1 (2007). The difficulty created by this observation is that it swaps what is more properly characterized as a “tension” with the idea of “agency” (which has a legal meaning and implications that differ from the idea of “tension”). This confusion of terms may lead to a change in the character of the relationships between shareholders given that it may give rise to agency relations between and among shareholders – a situations that is unnecessary and may pose a hurdle to the future development of the capital markets as investors who do not wish to be held out as agents for other investors may pull out of the public equity markets.

<sup>104</sup> One may question how a blockholder structure affords liquidity in the capital markets. To understand this, we need to remember that the emergent blockholder in the US is the institutional investor. The US markets (i) are treated and referred to as liquid markets and (ii) have developed over the years such things as trading platforms that afford liquidity to institutional investor holdings (i.e., block trading platforms), despite concerns regarding the impact of the growth of the institutional investor on the liquidity of the US capital markets in the past (see, e.g., Cohen, "An Address by Manuel F. Cohen, Chairman, Securities and Exchange Commission, before the American Bankers Association."),

<sup>105</sup> Coffee introduced these two strengths/features of the polar ownership structures as tradeoffs. Coffee, "Future as History," 648. Under the MOBM, however, these strengths/features are complements rather than tradeoffs.

Hence, the characterization of this ownership model as the Market Oriented Blockholder Model.<sup>106</sup>

The hybridization of the two polar ownership structures coupled with market mechanisms for resolving collective action problems work to place the MOBM in a competitive advantage relative to the polar models of ownership. The MOBM appears to align the US capital markets with other national economies in the sense that market forces in the US have been pushing for the partial concentration of ownership as a method for resolving the collective action problem that exists between shareholders.<sup>107</sup> The MOBM achieves this, however, without sacrificing liquidity in the US capital markets (the reduction in which is described as a cost resulting from re-concentration of ownership)<sup>108</sup>. Thus, even though institutional investors in the US own, and trade in, large blocks of equity, the US capital markets are still treated as having liquid secondary markets. In addition, by working harmoniously with such market mechanisms as control transactions, the model allows for the reduction of collective action problems.<sup>109</sup>

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<sup>106</sup> It is submitted that this is consistent with Fama's observation that "[t]he primary role of the capital markets is allocation of ownership of the economy's capital stock." Eugene F. Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work," *Journal of Finance* 25, no. 2 (1970): 383.

<sup>107</sup> Becht, Bolton & Roell, for example, noted that "[t]he favored mechanism for resolving collective action problems among shareholders in most countries appears to be partial ownership and control concentration in the hands of large shareholders." Becht, Bolton, and Röell, "Corporate Governance and Control (October 2002)." 1.

<sup>108</sup> Ibid.

<sup>109</sup> As Becht, Bolton & Roell noted: "[m]uch research on corporate governance has been concerned with the resolution of this collective action problem. Five alternative mechanisms may mitigate it: i) partial concentration of ownership and control in the hands of one or few large investors; ii) hostile takeovers and proxy voting contexts, which concentrate ownership and/or voting power temporarily when needed ..." (ibid.).

## **B. INFORMATION FLOWS FACILITATING THE TREND TOWARDS THE MOBM**

The trend towards the MOBM was facilitated by information. Two types of information flows are of particular relevance for the analysis. The first is that which operates at the *intra* level (i.e., the capital markets). The second operates at the *inter* level (i.e., between the capital markets, legal system, and political system). Both types of information involved the gradual and progressive internalization of input. This information had to be benchmarked against prior knowledge of the actors as the capital markets grew in size and maturity in order for progress towards the MOBM to be achieved.

Information at the *intra* level played a role in the self-regulatory nature (i.e., by market forces) of the trend towards the MOBM. Information about potentially good investment opportunities – of the value investment-grade type that provided stable dividends to its shareholders – became the staple investment targets for institutional investors. Information about under-performing firms that have a potential for increased returns on investment allowed institutional investors and corporate raiders to participate in the takeover environment. In addition, information about the growth of institutional investors and their needs facilitated technological advancements that allow for, and facilitate, institutional investor trading.

Information flows at the *inter* level – that which flows between the regulator/government and market actors (and, as such, forms part of the environment within which capital markets operate) – also played a role. As we saw, at times it worked to stimulate or support certain types of activity (e.g., see discussion vis-à-vis the ERISA, where policy measures such as taxation facilitated the concentration of equity in institutional investors such as pension funds); while at

other times it worked to enable certain types of activity (e.g., see discussion vis-à-vis amendment of the proxy rules in 1992).

### C. FAILURE TO GRASP THE TREND

Evolution in the ownership structure of the US publicly traded firm was also aided by theories that worked to empower the concentration of finance in institutional investors. These theories, however, did not treat institutional investors as blockholders or investors in the ordinary sense of the term. Despite treating different types of blockholders in a differential manner, however, it might be that proponents of agency theory are unconsciously proposing the gravitation towards a blockholder ownership structure. As Bratton explains, “agency theory, as it grapples to solve the problem of separated ownership and control in publicly held firms, turns again and again to the institutional investor community to look for some way to energise it into a productive governance role.”<sup>110</sup> Such an unconscious move, however, without the realization of its outcomes may have its limits.<sup>111</sup>

One reason for this differential treatment of various types of blockholders (i.e., the individual or retail type blockholder, on the one hand, and the institutional type, on the other) appears to be the undue preoccupation with large firms. This stems from (i) the biases inherited by the majority of the contributors to the literature from Berle and Means, and (ii) the neglect of the fact that the majority of the publicly traded firms in the US appear to have blockholders. These biases lent themselves to theories that internalized the biases to create a distorted image of

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<sup>110</sup> Bratton, "Private Equity's," 531.

<sup>111</sup> For a recent discussion on the limits of relying on institutional investors see, e.g., Bainbridge Bainbridge, "Shareholder Activism in the Obama Era".



the markets. Another reason, as already noted, appears to rest in the treatment of institutional investors as part of the diffusion process.

## **V. MOB M AS A TRANSFORMING AGENT IN THE GLOBAL CAPITAL MARKETS: A SHIFT FROM DIVERGENCE TO CONVERGENCE IN MARKETS**

An understanding of the evolution of the capital markets in the US contributes to the corporate governance convergence/divergence debate over the future directions that national and regional governments should adopt in order to promote efficiency in their respective capital markets. Some contributors to the literature argue that there is a movement by economies generally characterized as having concentrated modes of ownership towards a US-style mode of ownership.<sup>112</sup> Assuming such observations are valid, one needs to understand the direction towards which the US is moving.

Evidence of the movement towards the MOB M by the US suggests that convergence of global governance systems is feasible. This is due to the characteristics of the MOB M: a hybrid model – a blockholder model with market-oriented features. These features are in the process of internalization by economies characterized by the concentrated ownership model.<sup>113</sup>

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<sup>112</sup> See above note 6 and accompanying text.

<sup>113</sup> See, e.g., Clift Ben Clift, "French Corporate Governance in the New Global Economy: Mechanisms of Change and Hybridisation within Models of Capitalism," *Political Studies* 55, no. 3 (2007). Clift noted that although a frictionless transition towards the US/UK model of corporate governance in France is slow to happen, a hybridization process is taking place. See also Learner and Gurung who observed the global embrace of corporate control transactions. Lerner and Gurung, *Globalization of Alternative Investments 1*.

We can take this a little further. In addition to the feasibility of convergence, it is submitted that a movement by the two principal models of corporate governance, at the level of the markets, represents true convergence of the two systems rather than an exercise of catch-up by economies characterized by the concentrated ownership model towards the US model. This is so given that rather than having a unilateral movement by concentrated ownership economies (such as Germany and France) towards the US, we are witnessing a multi-lateral movement by various economies (including the US). This movement is towards the MOB, which represents an efficient equilibrium state of ownership that draws on the strengths of the polar states of ownership by providing both increased liquidity in the capital markets and increased monitoring.

The MOB and the above analysis answers the following comment made by Bratton and McCahery:

Politics can indeed explain why a governance system has not evolved so as to be first best. But it cannot by itself show us how to improve that system. For that one needs an economic theory of the firm. No economic theory yet articulated shows us how to splice blockholder components onto market systems so as to effect material improvements.<sup>114</sup>

It is suggested that this chapter has addressed Bratton and McCahery's concern, by looking to align corporate governance theory with market realities. In doing so, the paper contributes to the discourse on the convergence/divergence debate and shows that the objective of global convergence of corporate ownership models can be achieved, and in this way allow economies reap the potential benefits of financial globalization.

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<sup>114</sup> William W. Bratton and Joseph A. McCahery, "Comparative Corporate Governance and Barriers to Global Cross Reference," in *Corporate Governance Regimes: Convergence and Diversity*, ed. Joseph A. McCahery, et al. (Oxford; New York: Oxford University Press, 2002), 47.

Convergence is feasible given that we only need functional convergence (i.e., attainment of similar results via different formal rules). This is because the focus of the model is the maintenance of ownership equilibrium, at the blockholder levels, which enables the effective contribution by shareholders to both the allocation and governance functions of the markets. So long as this equilibrium is achieved and maintained, different market systems can retain sufficient flexibility to allow for differences in formal rules. As Gordon and Roe explain, “[f]unctional convergence focuses on adaptability: when it’s strongly in play, different regimes, despite formal differences, can cobble together existing institutions to fulfill new demands.”<sup>115</sup>

Thus, in addition to enhanced efficiency within the capital markets (due to the improved performance of the allocation and governance functions) that the MOBM leads to, the functional convergence it facilitates would enable increased coherence and consistency between different economies.

## VI. CONCLUSION

The chapter traced the evolution in the pattern of ownership in the US public firm. It has revealed that over the past number of decades the US markets have been gravitating towards the MOBM. The process became more accentuated after World War II, with the institutionalization of the US capital markets, the growth in importance of institutional investors due to socio-political and economic factors, and the support of the political sphere. The discussion, however,

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<sup>115</sup> Jeffrey N. Gordon and Mark J. Roe, "Introduction," in *Convergence and Persistence in Corporate Governance*, ed. Jeffrey N. Gordon and Mark J. Roe (Cambridge, UK; New York: Cambridge University Press, 2004), 1.

identified that the literature has been unsuccessful in appreciating that the pattern of ownership in the US capital markets was becoming a variant of the blockholder ownership structure.

The chapter also touched on the international implications of the MOB. At this level, regardless of whether one subscribes to the idea of global harmonization in the area of corporate governance or not, realities on the ground point to such a movement. It was noted in the outset of this chapter that there is a movement towards a US-style outsider system, characterized by an internalization or adoption of US patterns of corporate ownership; corporate ownership being the key factor distinguishing different systems of corporate governance.<sup>116</sup> The MOB reflects this trend. This lends support to, and is supported by, Easterbrook's comment that "international differences in corporate governance are attributable more to differences in markets than to differences in law. Law is an output of this process, not an input."<sup>117</sup> Thus, as differences in ownership patterns around the globe are diminishing in favour of the MOB, legal systems should be able to respond to market realities (where such a response will not be based on a distorted understanding of the markets).

The chapter did not explore the implications of the MOB to corporate governance to a great extent. A student of the subject, however, should recognize that the importance and value of identifying the MOB extends beyond mere description. This is because there is a causal link between ownership structures and approaches to corporate governance and corporate law.

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<sup>116</sup> Recall the comment by Wymeersch that "ownership structure seems the single most significant variable factor in explaining differences in governance structures." Wymeersch, "Convergence."

<sup>117</sup> Frank H. Easterbrook, "International Corporate Differences: Markets or Law?," *Journal of Applied Corporate Finance* 9, no. 4 (1997): 29. This statement suggests that the political and legal systems, once they recognize the market's gravitation towards the MOB, would necessarily respond and formally accommodate this transformation.

As Bebchuk and Hamdani<sup>118</sup> recently observed, ownership structures have implications for a number of key governance arrangements: “those regulating control contests, voting procedures, the allocation of power between directors and shareholders, the distribution of power among shareholders ... director independence, and corporate transactions that may divert value to insiders.”<sup>119</sup> Bebchuk and Hamdani, whose analysis is limited to the two polar ownership structures (i.e., diffused and concentrated), note that the impact each of these governance arrangements on outside investors depends on whether the firm’s ownership structure is diffused or concentrated. The discussion in this paper and the recognition of the MOBM add a wrinkle to Bebchuk and Hamdani’s analysis (given that the MOBM represents a middle ground between the polar ownership structures in the literature) by indicating that concerned observers may need to re-examine the academic literature on ownership structures and corporate governance based on the MOBM.

An example will illustrate the point. The SEC recently published a proposed rule for comment offering to amend the federal proxy access rules in order to facilitate the nomination of directors by shareholders and, thus, improve board accountability and governance.<sup>120</sup> The aim of the initiative is the empowerment of shareholders by allowing them to nominate directors. The

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<sup>118</sup> Bebchuk and Hamdani, "Elusive Quest."

<sup>119</sup> Ibid., 1270. See also contributions to Kraakman, *Anatomy of Corporate Law*. Kraakman noted that ownership structure affects such matters as (i) takeovers and defensive measures adopted by firms to thwart such activity, (ii) conflict of interest rules and related party rules, and (iii) significant corporate action and disclosure rules.

<sup>120</sup> Referring to the Proposal, *supra*, note 82. Similar proposals have been made in the past, see, e.g. Murphy who noted that proposals for shareholder nominated directors date back to the 1940s Michael E. Murphy, "The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis," *Berkeley Business Law Journal* 5(2008)..

Proposal, inter alia, recommends a tiered system with various ownership thresholds (both in size and duration of holding) depending on the size of the corporations in order to allow shareholders who meet the criteria to nominate a director to the corporation's board.

The Proposal, if submitted, reinforces (and supplements) the trend towards the MOB in the American capital markets. The Proposal invariably strengthens the voice of financial blockholders who are able to meet the Proposal's threshold criteria and who seem to support the initiative.<sup>121</sup> In so doing, the Proposal creates an environment that aids such investors in influencing the board of directors in a manner that is akin to non-financial blockholders and may, potentially, detract from the sought after aim of protecting outside investors.<sup>122</sup>

Yet, one may question the strength of the Proposal based on one of its fundamentals. The idea of inclusion of shareholder proposals in proxy materials under Federal law appears to rest, historically, on the notion that ownership in the US public firm is diffused<sup>123</sup> and this notion

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<sup>121</sup> See, e.g., Sarah N. Lynch, "Business Groups Gear Up To Fight SEC Proxy Access Proposal," *Dow Jones Newswires*, 18 August 2009.

<sup>122</sup> See note 103. See also Bebchuk and Hamdani who noted (at 1295), in the context of concentrated ownership structures, that "giving the majority shareholders more power vis-à-vis the board would operate to weaken – not enhance – the protection of outside investors." Bebchuk and Hamdani, "Elusive Quest." Unfortunately their position vis-à-vis such initiative in the context of diffused ownership structures is less clear. As they note, at 1294, "there is no dispute that the allocation of power between boards and shareholders can have a substantial impact (for better or worse) on outside investors ... These arrangements are likely to significantly influence corporate decisions by affecting the extent to which directors and officers are attuned to the preferences of the majority shareholders" – or, we can add, the blockholders.

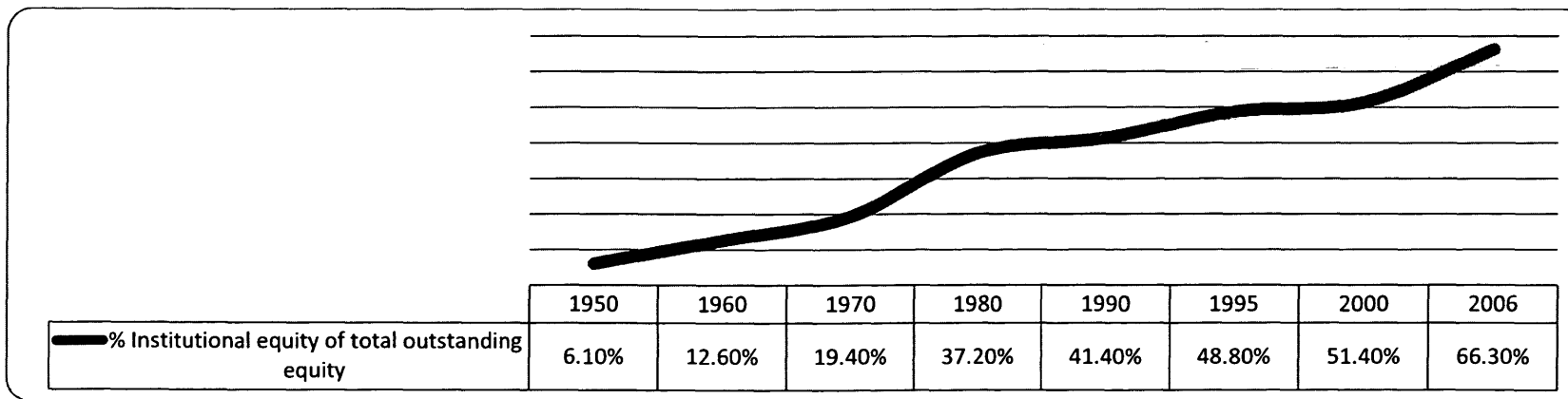
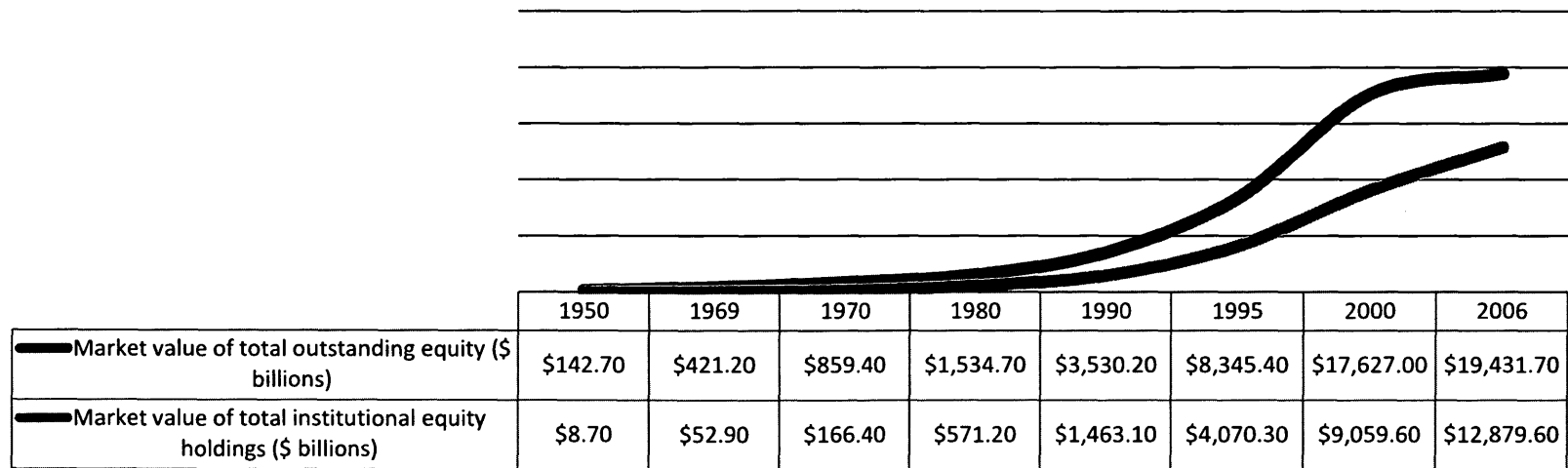
<sup>123</sup> Proposal, note 82, 29025.

remains a key assumption for the SEC.<sup>124</sup> As such, the realization of the MOB as correctly representing ownership patterns in the US may merit a re-examination of the Proposal and other similar initiatives. Such re-examination is expected to change the balance between the proponents and opponents of the Proposal.

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<sup>124</sup> Ibid, 29031.

**Figure 1, Growth of institutional investors relative to the market, 1950-2006 (Source: The 2008 Institutional Investment Report, Conference Board 2008)**





**Figure 2, Concentration of institutional investor holdings in the largest 25 corporations as of December 31, 2007 (Source: The 2008 Institutional Investment Report, Conference Board 2008)**



**Table 1, Institutional investor concentration of ownership in the top 1,000 US: 1987 vs. 2007 as of December 31, 2007 (Source: The 2008 Institutional Investment Report, Conference Board 2008)**

Top corporations	Average institutional holdings (%)		
	1987	2007	% Point change: 1987-2007
Top 50	48.7%	63.3%	14.6%
Top 100	53.6	67.5	13.9
Top 250	52.8	71.8	19.0
Top 500	51.8	75.3	23.5
Top 750	49.6	76.2	26.6
Top 1,000	46.6	76.4	29.8

## CHAPTER 3, INSTITUTIONAL INVESTORS AS BLOCKHOLDERS\*

Pichhadze (2010) introduced the Market Oriented Blockholder Model (MOBM) as properly describing the ownership pattern of corporations listed in the American equity markets. Under the model the emerging blockholder in the American equity markets is the institutional investor (II). This poses a challenge to the shareholder primacy literature, which argues that IIs (i) have interests that coincide with the interests of the shareholder body in the public firm, (ii) promote dispersed ownership, and (iii) crusades for shareholder interests domestically and internationally. I show that (i) the position of institutional investors as blockholders creates a paradox for both the literature and the law, (ii) IIs have interests that do not coincide with those of other shareholders, and (iii) failure to recognize these observation vis-à-vis IIs or MOBM may result in the introduction of a systemic risk into the financial system.

### I. INTRODUCTION

In describing the rise to prominence of the shareholder-oriented model of the corporate form, Hansmann and Kraakman<sup>1</sup> noted, inter alia, that this process involved the diffusion of public

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\* This chapter will appear in Pichhadze, Aviv, "Institutional Investors as Blockholders," P.M. Vasudev & Susan Watson, eds., *Corporate Governance After the Financial Crisis* (Edward Elgar, forthcoming). It is an updated version of Pichhadze, Aviv, 2010. "Institutional Investors as Blockholders," Osgoode CLPE Research Paper No. 13/2010. Available on SSRN: <http://ssrn.com/abstract=1600743>, which was presented in Aviv Pichhadze, "Institutional Investors as Blockholders", *Corporate Governance in the Post, Post-World: The Public/Private Debate*, The Corporate Governance Symposium April 9-10 2010, The New Zealand Governance Centre, The University of Auckland Business School, New Zealand, April 9, 2010.

firm ownership and the rise to prominence of the institutional investors. In the context of institutional investors, Hansmann and Kraakman noted that the interests of this shareholder group coincide “with those of public shareholders and ... [institutional investors] are prepared to articulate and defend those interests.”<sup>2</sup> In addition, they note that “[t]hese institutions not only give effective voice to shareholder interests, but promote in particular the interests of dispersed public shareholders rather than those of controlling shareholders or corporate insiders.”<sup>3</sup> Finally, in this context, they note that “the new activist shareholder-oriented institutions [i.e., institutional investors] are today acting increasingly on an international scale. ... We now have not only a common ideology supporting shareholder-oriented corporate law, but also an organized interest group ... that is broad, diverse, and increasingly international ... .”<sup>4</sup>

Accordingly, institutional investors seem to (i) have interests that coincide with the interests of the shareholder body in general in the public firm, (ii) promote dispersed ownership, and (iii) crusade shareholder interests internationally. Hence, they play an important role in corporate governance both domestically in the US and internationally. In this chapter, I examine these three propositions. I do this against the background of Pichhadze’s Market Oriented Model

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<sup>1</sup> Henry Hansmann and Reinier Kraakman, "The End of History for Corporate Law," in *Convergence and Persistence in Corporate Governance*, ed. Jeffrey N. Gordon and Mark J. Roe (Cambridge: Cambridge University Press, 2004), 48-49.

<sup>2</sup> *Ibid.*, 49.

<sup>3</sup> *Ibid.*, 50.

<sup>4</sup> *Ibid.*

(MOBM) that shows that the new blockholder in the American public equity markets is the institutional investor.<sup>5</sup>

This assessment is both timely and important as policymakers around the world are looking to fundamentally reform the global financial system and its various components.<sup>6</sup> These reform initiatives are pursued with the view to correcting, in a coordinated and harmonized manner, the failures that led to the recent economic crisis. The initiatives cover various levels and aspects of the financial system and include such things as transparency, risk management, supervision, regulation, and corporate governance.<sup>7</sup> This chapter is concerned with the last area of proposed reforms – corporate governance. It is in this area that institutional investors play a

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<sup>5</sup> Aviv Pichhadze, "The Nature of Corporate Ownership in the USA: The Trend Towards the Market Oriented Blockholder Model," *Capital Markets Law Journal* 5, no. 1 (2010). Given that the literature on corporate ownership structures does not make an explicit differentiation between the concentrated and the blockholder modes of ownership (and they are generally used interchangeably), for the sake of clarity, I divide the spectrum of public firm ownership into three clusters: concentrated ownership represents ownership levels in excess of 50.1% of the firm's outstanding shares; blockholder ownership represents ownership levels between 5% and 50%; and dispersed ownership represents ownership level below the 5% levels. The choice of the 5% threshold is based on the requirements under s. 13(d), Securities Exchange Act of 1934, 15 U.S.C.A. Ch. 2B, inter alia, for disclosure of beneficial ownership of 5% or more by any person of the outstanding shares of a firm's securities subject to Securities Exchange Act. One should note, however, that while the above are used as a general guide, these lines of demarcation are fluid, subject to change from one firm to another based on factors such as the size of the firm and shareholdings of individual investors.

<sup>6</sup> OECD, "Policy Framework for Effective and Efficient Financial Regulation: OECD Recommendation and Principles," (Paris, France: Organisation for Economic Co-operation and Development, 2009).

<sup>7</sup> ———, "OECD sets out framework for overhaul of financial regulation," Organisation for Economic Co-operation and Development, [http://www.oecd.org/document/44/0,3746,en\\_21571361\\_44315115\\_44180524\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/44/0,3746,en_21571361_44315115_44180524_1_1_1_1,00.html).

significant role – a role that needs to be assessed for the purpose of promoting a stable and efficient global financial system.

The chapter is organized around three themes. First, in Part I, I show that the fact that institutional investors promote diffused ownership is a paradox given that they are the emerging blockholder in the equity markets, in general, and in large firms, in particular. Second, in Part II, I examine the extent to which institutional investor interests are aligned with those of other shareholders. More specifically, the chapter seeks to examine whether institutional investors behave in a manner that is not dissimilar to that of non-financial (e.g., retail or family) blockholders or controlling shareholders. Finally, in Part III, the chapter will address some regulatory implications, both domestically in the US and internationally, of the fact that institutional investors are the emergent blockholder. Part IV provides some concluding remarks.

## **I. INSTITUTIONAL INVESTORS AND THE PROMOTION OF DISPERSED OWNERSHIP – THE PARADOX**

As can be seen from above, institutional investors are said to shepherd the interests of dispersed owners and, in so doing, promote dispersed ownership as the appropriate form of public firm ownership in the equity markets. Yet, institutional investors are the emergent blockholder in the American equity markets holding over 66% of the equity in these markets.<sup>8</sup> Thus, we have a

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<sup>8</sup> Brancato and Rabimov, *2008 Report*; James Hawley and Andrew Williams, "Universal Owners: Challenges and Opportunities," *Corporate Governance: An International Review* 15, no. 3 (2007). As Hawley and Williams pointed out, ownership is further concentrated within the class of institutional investors, "... most importantly, while there are many institutional investors, holdings are, in fact, concentrated in the hands of a relatively small number of the

paradox between the stated purpose or objective of institutional investors in promoting dispersed ownership, on the one hand, and the reality of institutional investors as a blockholder, on the other. To understand how we arrived at this paradox, we need to examine the ownership trend in the American equity markets over the course of the 20<sup>th</sup> century.

Institutional investors in the US developed during the early years of the capital markets in that country and increased their exposure to equity investments during the 1950s. By the end of the 1950s the observed pattern in share ownership “was that individuals were shifting their capital from direct share ownership to institutional investments and bank deposits.”<sup>9</sup> By the end of the 1960s, interested observers were talking about the institutionalization of the American capital markets,<sup>10</sup> a process that continues to this present day and sees the re-concentration of public corporate equity into the hands of institutional investors.

The process of the institutionalization of the American capital markets and the associated re-concentration of corporate ownership into the hands of institutional investors were an integral part of the trend towards MOBAM, as market forces were driving ownership patterns in the publicly listed firm towards the blockholder levels of ownership. Yet, since the early years of the American capital markets, institutional investors were treated as vehicles for diffusion, rather than concentration of ownership.<sup>11</sup> In addition, some went as far as to proclaim that institutional

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very largest institutional investors. For example, in the USA, the 100 largest fiduciary institutions hold fully 52 per cent of *all* publicly held equity” [emphasis in the original]. Ibid., 415.

<sup>9</sup> Pichhadze, "Market Oriented Blockholder Model," 68.

<sup>10</sup> Ibid., 73.

<sup>11</sup> See generally *ibid.*, 68-71, 73-79.

investors "are the trustees for all shareholders. They establish the moral tone in Wall Street."<sup>12</sup> A point of view that is both contradictory and forms the basis for the paradox.

MOBM is a hybrid ownership structure that features blockholder pattern of ownership that works with market mechanisms for the promotion of maintaining stability in the pattern of ownership (i.e., the maintenance of ownership equilibrium at the blockholder levels). The emergent blockholder in the US, as already noted, is the institutional investor. The synthesis of the blockholder mode of ownership with market mechanisms, such as takeovers, allows for the transformation of what Coffee<sup>13</sup> described as the trade-offs between the monitoring of corporate managers and the promotion of efficient and liquid markets resulting from the choice of the two polar ownership structures (i.e., concentrated and diffused, respectively) into complements.<sup>14</sup>

MOBM is created through the need of market forces to arrive at an ownership equilibrium that affords both liquidity in the capital markets and monitoring of corporate management. MOBM is facilitated by market mechanisms that assist in the promotion of such an equilibrium and its maintenance over time. Maintenance is required because the ownership equilibrium, once achieved, does not remain static, rather it is a dynamic process that exhibits deviations from, and restoration to, the state. In this dynamic process, market mechanisms such as corporate control transactions (including private equity) have an important role in restoring the equilibrium state, when disturbances occur or there are deviations from the state of equilibrium.

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<sup>12</sup> Livingston, *American Stockholder*, New, rev: 216.

<sup>13</sup> Coffee, "Future as History."

<sup>14</sup> Pichhadze, "Market Oriented Blockholder Model."



Pound observed in the context of leveraged buyout transactions, “[o]versight by entrepreneurial insurgent investors has been generated by two central (and related) features of U.S. capital markets: their fragmentation and their openness to innovation.”<sup>15</sup> According to this view, when the ownership of a public firm becomes too fragmented such that (i) the firm experiences a reduction in the effective monitoring of the firm’s management, and (ii) such reduced monitoring results in the introduction of inefficiencies to the firm, then (iii) market mechanisms such as takeover activity introduce into the firm improved monitoring and enhanced efficiency by, inter alia, concentrating, at least temporarily, the ownership of the firm.

Thus, advancement of MOBМ required two principal realizations by market forces. First, as industrial blockholders were diminishing from the large public corporation landscape during the early part of the 20<sup>th</sup> century, market forces, in looking to fill the ownership gap, were re-concentrating ownership in the hands of fiduciaries who could take up the role of blockholders in these firms.<sup>16</sup> Second, to achieve/maintain stability in this form of ownership, institutional investors, *qua* blockholders, realized that (in order to protect their investment, ensure increased returns on such investment, and ensure liquidity for such investments) they needed to participate in the market for corporate control, as they have done since the 1980s.

In order to facilitate their fuller participation in this type of activity, institutional investors successfully lobbied for amendments to legal rules, such as the proxy rules which prevented their fuller participation in the takeover arena.<sup>17</sup> This was complemented by active investors who, as

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<sup>15</sup> Pound, "Raiders," 8.

<sup>16</sup> According to Livingston, institutional investors are as important as non-financial blockholders for the purpose of monitoring corporate managers. Livingston, *American Stockholder*, New, rev: 57, 210.

<sup>17</sup> See, e.g., Pichhadze, "Market Oriented Blockholder Model," 79.

gap fillers in the corporate governance vacuum created as a result of fragmented ownership, realized the dual role and importance of institutional investors both as providers of capital and as blockholders in the execution of deals.

Thus, the paradox in the American capital markets vis-à-vis institutional investors is that while they are viewed as promoting diffused ownership in both the US and elsewhere, they are in fact blockholders in these markets. While paradoxical in the context of institutional investors, in the context of the MOB, however, the fact that the MOB is the emerging ownership pattern in the US shows us that market forces in that country are driving ownership patterns towards what can be said to be an optimal ownership structure that is also socially optimal.

Social optimality in the context of the corporation refers to the notion that the shareholders' representatives serve the shareholders' interest.<sup>18</sup> One way of ensuring that this social welfare is met in the context of the corporation is through the monitoring of managers. The problem is that, absent anyone owning sufficient stakes in the corporation, monitoring is left to market-mechanisms such as takeovers.<sup>19</sup> Market forces and socio-economic realities, however, created a venue for the promotion of social optimality in the corporation. They have paved the way for the re-concentration of equity ownership into the hands of institutional investors, who have sufficient stake in the corporation and, therefore, an interest in monitoring corporate managers.

Institutional investors, as blockholders, and takeovers are also two key features in MOB. They promote efficiency and liquidity in the capital markets while enabling the

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<sup>18</sup> Sanford J. Grossman and Oliver D. Hart, "Takeover Bids, The Free-Rider Problem, and the Theory of the Corporation," *The Bell Journal of Economics* 11, no. 1 (1980).

<sup>19</sup> Ibid.

increased monitoring of corporate managers. In addition, given that a feature of MOBM is the presence of a blockholder (whether an institutional investor or not), it points to the observation that market forces, in gravitating towards MOBM, are attempting to reduce the sub-optimality created by the diffused ownership pattern of corporate ownership.<sup>20</sup>

Care, however, should be exercised in reading the above. While MOBM may be structurally and, probably, socially optimal as an ownership structure, it does require a shift in regulatory thinking and approaches to corporate governance. This shift, and its nature, is not immediately available in the standard literature on corporate governance and, as such, there is no immediate “off-the-shelf” solution.

This is because the literature generally provides analysis of, and solutions to, cases involving the two polar extremes of corporate ownership (i.e., dispersed and concentrated). Whereas under the dispersed mode of ownership, regulation seeks to protect shareholders from managers, under the concentrated mode of ownership, regulation seeks to protect the shareholder class from the controlling shareholder.<sup>21</sup> There are no solutions contemplated (or, indeed, discussed) to cases such as MOBM.<sup>22</sup>

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<sup>20</sup> Lucian A. Bebchuk and Luigi Zingales, "Ownership Structures and the Decision to Go Public: Private versus Social Optimality," in *Concentrated Corporate Ownership*, ed. Randall K. Morck (Chicago; London: University of Chicago Press, 2000). The assumption in the Bebchuk and Zingales analysis appears to be that going public translates into the assumption of diffused ownership structure for the corporation (i.e., atomistic share ownership).

<sup>21</sup> Bebchuk and Hamdani, "Elusive Quest."

<sup>22</sup> For example, Bebchuk and Hamdani (2009), in an analysis of corporate governance evaluation systems, note “[a]t the outset, we should acknowledge that some public companies lie in the gray area between those pure types because they have a dominant shareholder with substantial influence but not a complete lock on control. We leave it for another day the refinement of our analysis necessary for extending it to such companies.” Ibid., 1271. The omission

## II. INSTITUTIONAL INVESTORS AS BLOCKHOLDERS

Institutional investors are not a homogeneous group. They include pension funds, insurance companies, banks, and mutual funds to name a few. Despite this, they have generally come under criticism as owners of equity (in monitoring portfolio firms) and for failing to function as fiduciaries (on behalf of the investors that entrust them with their savings). For example, it was commented that “[h]istorically, millions of investors have acted like renters of corporate shareholdings rather than fractional owners of actual companies. Even worse, so do many of the mutual funds, retirement systems, and other fiduciaries to which citizen investors have entrusted their assets.”<sup>23</sup>

In this section of the chapter, I examine the behavior of institutional investors *qua* shareholders, using a number of examples, to see whether they behave in a manner that is distinct from other non-financial blockholders. Prior to this, however, let us briefly look at the arguments claiming that institutional investors fail in their function as fiduciaries.

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from their analysis of those companies that fall in the “gray area” is unfortunate given that they form the bulk (as oppose to “some” as argued by Bebchuk and Hamdani) of the companies found in the US equity markets. See, e.g. Pichhadze, "Market Oriented Blockholder Model," 71 and references cited therein.. In addition, their discussion is premised on the notion that blockholder ownership pattern are not conducive to market mechanisms such as takeovers.

<sup>23</sup> Stephen M. Davis, Jon Lukomnik, and David Pitt-Watson, *The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda* (Boston, Mass.: Harvard Business School Press, 2006). 66.

### III. INSTITUTIONAL INVESTORS AS FIDUCIARIES – SOME INDUSTRY SHORTCOMINGS

Davis, Lukomnik and Pitt-Watson provide a number of reasons for institutional investors' failure in their role as fiduciaries. These criticisms relate to the fund industry in general and include (i) the manner in which fund managers get compensated, (ii) lack of economic incentive to monitor portfolio firms, (iii) the investment horizon of fund managers, and (iv) lack of member input and/or representation on corporate pension funds.

The first criticism results from the manner in which fund managers' compensation is calculated. In this context the authors note that because fund managers are paid on a percentage-of-assets basis (i.e., fees are based on the quantum of assets under management), fund managers have little (economic) incentive to monitor the assets under their care.<sup>24</sup>

Another reason is the investment horizon adopted by fund managers. The authors note that the fund industry rates fund managers' performance based on their relative performance over short time frames. These ratings translate themselves into bonus for individual managers and analysts. "The natural result is that they [i.e., fund managers and analysts] focus on lucrative short-term trading rather than on vigilant long-term owning."<sup>25</sup>

A related reason for the failure of fiduciaries to act like owners according to the authors is the fact that the economic cost of monitoring does not result in a corresponding financial benefit to the individual fiduciary as all investors will share in the benefits resulting from the monitoring

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<sup>24</sup> Ibid., Chapter 4.

<sup>25</sup> Ibid., 72.

activities by the particular institutional investor. As such, fund managers prefer to beat market benchmarks (i.e., exhibit improved relative performance).<sup>26</sup>

A final criticism of institutional investors relates to pension funds. In this context Davis, Lukomnik and Pitt-Watson note that “many pension funds around the world operate with no representation at all from the very members they are supposed to benefit. Almost all corporate pension funds in the United States and Japan ... are run exclusively by company officials, with no such thing as a trustee board with seats for current or retired employees.”<sup>27</sup> In addition, the authors note that this practice allows corporate managers to hire fund managers that will not oppose management for fear of losing the company’s fund business – i.e., fund managers do not exercise the ownership rights on behalf of the pension funds’ beneficiaries.

#### **IV. INSTITUTIONAL INVESTORS AS OWNERS**

Despite some of the shortcomings of institutional investors at the industry level, institutional investors do perform and act as equity owners. It is worth examining their actions as shareholders in light of the fact that they are the emerging blockholders in the capital markets and the fact that they can potentially perform a valuable corporate governance function at both the domestic and international levels. In this section, institutional investors are treated as a homogeneous group for the sake of simplifying the discussion. While institutional investors,

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<sup>26</sup> Ibid.

<sup>27</sup> Ibid., 75.

generally, are treated in the discussion below as a homogeneous group, shareholders are not. This is because shareholders have interests that are not common with other shareholders.<sup>28</sup>

The literature on corporate governance identifies several potential areas where a dominant shareholder can negatively impact the corporation and, as such, other shareholders. While a complete catalogue is beyond the scope of this chapter, I examine some of these areas to see if institutional investors have the capacity of behaving in a like manner. This will enable us to assess whether, on balance, institutional investors act as a dominant shareholder or a blockholder for the purposes of impacting corporate performance. This is important because the two types of shareholders (i.e., institutional investors, on the one hand, and blockholders, on the other) are generally treated differentially in the literature. In particular, I focus on (i) corporate boards and management catering to shareholder interests, (ii) ability to exercise formal power, and (iii) rent seeking and opportunism.

#### **A. BOARD CATERING TO SHAREHOLDER INTERESTS**

In firms with a controlling shareholder there is the risk that management and the board of directors will follow the direction of the blockholder(s) while ignoring the interests of minority shareholders. "The agency problem here is the possible conflict of interest between the dominant shareholder (supported by the officers and directors who are under the dominant shareholder's control) and other shareholders."<sup>29</sup>

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<sup>28</sup> Iman Anabtawi, "Some Skepticism About Increasing Shareholder Power," *UCLA Law Review* 53(2005).

<sup>29</sup> Ronald J. Daniels and Randall Morck, "Canadian Corporate Governance: The Challenge," in *Corporate Decision-Making in Canada*, ed. Ronald J. Daniels and Randall Morck, *Industry Canada Research* (Ottawa: University of Calgary Press, 1995), 12.

In the context of institutional investors, this raises the question of whether institutional investors receive (whether actual or perceived) special treatment from managements of boards. Recent developments in the capital markets point to the growing recognition by boards and managements of leading corporations of the important power of institutional investors *qua* blockholders. This has recently been observed by the American Bar Association Section of Business Law :

Boards also are more actively engaging in discussions with shareholders on a variety of governance related topics outside of the proxy proposal context, including nomination of directors, compensation matters, social and environmental issues, and the range of matters raised by shareholders during proxy season. Pfizer, UnitedHealth, and Home Depot, for example, initiated meetings with *large institutional investors* to discuss issues ranging from executive compensation to board composition.<sup>30</sup> [Emphasis added]

Does this mean that Pfizer and other corporations are serving the interests of large institutional investors at the expense of the remaining shareholder body? Not necessarily. But it does create a risk. First, such activity by corporations appears to signal that corporations are listening to institutional investors in a manner that is not too dissimilar to listening to a non-financial blockholder (i.e., providing a preferential treatment to institutional investors over other shareholders). Similarly, Anabtawi and Stout noted that institutional investors can, in some instances and contrary to conventional understanding, act in a manner similar to that of a

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<sup>30</sup> Task Force of the ABA Section of Business Law, "Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles and Responsibilities," *Business Lawyer* 65, no. 1 (2009): 107.



controlling shareholder in influencing corporate conduct.<sup>31</sup> Second, as Friday and Cram caution, “[d]irectors should ... be wary ... Activist shareholders are often motivated by their own economic, social or political agendas and do not necessarily speak for the silent majority of investors.”<sup>32</sup>

## **B. ABILITY TO EXERCISE FORMAL POWER**

It is generally accepted that dominant shareholders are likely to use formal powers to maximize the value of the share it owns.<sup>33</sup> In a widely held firm the likelihood for this type of activity is less likely because “collective action and free-rider problems ... often prevent outside shareholders from effectively using whatever formal powers that they have to constrain and influence management.”<sup>34</sup>

While these assertions may be true in the polar cases of ownership structures (i.e., diffused and concentrated), Pichhadze, in his MOBM analysis, notes that institutional investors are using legal tools to influence corporations.<sup>35</sup> For example, institutional investors are successfully using the proxy system and other shareholder rights mechanisms as well as lobbying

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<sup>31</sup> Iman Anabtawi and Lynn Stout, "Fiduciary Duties for Activist Shareholders," *Stanford Law Review* 60, no. 5 (2008): 1285-86.

<sup>32</sup> N. Kathleen Friday and Tracy Crum, "Top 10 Topics for Directors in 2008," *Corporate Governance Advisor* 16, no. 3 (2008): 12.

<sup>33</sup> Bebchuk and Hamdani, "Elusive Quest," 1283. However, it has also been observed by Daniels and Morck that “[d]ominant shareholders are perhaps less likely deliberately to push the firm toward non-value-maximizing activities ... After all, the dominant shareholder pays a high percentage of the cost himself.” Daniels and Morck, "Canadian Corporate Governance," 13.

<sup>34</sup> Bebchuk and Hamdani, "Elusive Quest," 1282.

<sup>35</sup> Pichhadze, "Market Oriented Blockholder Model," 75-79.

with the SEC to introduce changes for the removal of barriers to enable fuller institutional investor participation in corporate affairs.

### C. RENT SEEKING AND OPPORTUNISM

Shareholders are a group. As such, it allows them to benefit from the cooperative actions of group members.<sup>36</sup> Such gains, however, are balanced against the negative impact of activities such as rent-seeking and opportunism carried out by some group members at the expense of others. This is because shareholders, as a heterogeneous group, have their own interests in addition to the common interests.

Rent seeking is “the socially costly attempt to obtain wealth transfers.”<sup>37</sup> In firms with dominant shareholders, for example, Bebchuk and Hamdani<sup>38</sup> noted that the dominant shareholders can use self-dealing transactions to extract value. Anabtawi and Stout observed that this situation can also arise with institutional investors in countries such as the US (i.e., where ownership is assumed to be diffused), as in the case where institutional investors represent and promote their own interests.<sup>39</sup> This relates to the risks associated with interplay between interest group politics and diffused ownership. The risk was highlighted as far back as 1925 where it was

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<sup>36</sup> In corporate law, efforts by institutional investors during the 1990s to reduce restrictions on shareholder communications (ibid., 81.) may be thought of as an example of such efforts. Yet, even this example is subject to a qualification. Institutional investors were arguing in support of the proposed changes claiming that they were long-term investors whereas the evidence was to the contrary (ibid.).

<sup>37</sup> Anabtawi, "Some Skepticism about Shareholder Power," 575.

<sup>38</sup> Bebchuk and Hamdani, "Elusive Quest," 1283-84.

<sup>39</sup> Anabtawi and Stout, "Fiduciary Duties," 1285-86.

cautioned that interest groups (whether left- or right-wing), in advancing their interests, might use diffused ownership to their advantage.<sup>40</sup>

A related type of rent seeking is the political rent seeking. Here, public choice theory provides that larger groups will be "more inclined to produce pressure in the pursuit of group-specific public goods."<sup>41</sup> An example of this can be found in the efforts of institutional investors to influence the composition of corporate boards. While the SEC's proposed rule<sup>42</sup> is couched in language that is embracive of all shareholders in allowing them to participate in the process of nominating directors, the threshold requirements are such that only a select group of shareholders can meet these requirements.<sup>43</sup> This select group is composed mainly of institutional investors who, as a consequence of the size of their holdings, can meet the threshold requirements.

This type of rent seeking (i.e., influencing the representatives) also manifests itself at the level of the corporation and may provide another example for the conflict of interest between institutional investors and other shareholders. For example, where an institutional investor has cross-ownership in both the target and the bidding firms in cases of takeover transactions, the institutional investor can limit losses associated typically with the holdings of the bidding firm.<sup>44</sup> Such crossholdings also translate to the reduction in the wealth of non-crossholding

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<sup>40</sup> Samuel McCune Lindsay, "The Economic Revolution in the Ownership of Property in the United States," *Proceedings of the Academy of Political Science in the City of New York* 11, no. 3 (1925): 2-3.

<sup>41</sup> Frans Winden, "Interest Group Behavior and Influence," in *The Encyclopedia of Public Choice*, ed. Charles K. Rowley and Friedrich Schneider (Springer US, 2003), 120.

<sup>42</sup> Facilitating Shareholder Director Nominations, 17 CFR Parts 200, 232, 240, 249 and 274 [Release Nos. 33-904660089; IC-28765; File No. S7-10-09].

<sup>43</sup> Pichhadze, "Market Oriented Blockholder Model," 87-88.

<sup>44</sup> Anabtawi and Stout, "Fiduciary Duties.," Matvos and Ostrovsky, "Cross-ownership."

shareholders. This is because while the crossholding institutional investor seeks to optimize its return resulting from a transaction, it does so at the expense of the non-crossholding shareholder (or even a crossholding institutional investor with the “wrong” weight of stockholdings in either of the companies). The attempted takeover of Yahoo! by Microsoft in 2008 provides an illustration of this.

In the proposed transaction, Microsoft made a \$44.6 billion bid for Yahoo! It was reported that nearly 90% of Yahoo’s institutional investors had crossholdings in Microsoft, and most of Yahoo’s top 20 institutional investors were also significant holders in Microsoft. “What’s the implication? Any concession by Yahoo! to Microsoft’s \$44.6 billion buyout has to benefit both holdings in order to be a net benefit to shareholders ... ‘in theory an institutional shareholder may be likely to support a transaction, even one that is a poor deal for one side, provided the other side reaps a greater reward.’”<sup>45</sup> Thus, “[w]ith most of Yahoo!’s top investors having greater dollar exposure to Microsoft stock than Yahoo! Shares in their portfolio ... the most likely scenario is that ‘we can expect shareholders who own both companies to pressure Yahoo directors to extract a material sweetener from Microsoft...’”<sup>46</sup>

#### **D. SUMMARY**

The above discussion and examples point to the shortcomings in Hansmann and Kraakman’s observations made at the outset of this chapter vis-à-vis institutional investors. More specifically, the discussion showed that institutional investors interests do not coincide with those of other shareholders and, indeed, are often in conflict with those of the shareholder body as a whole.

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<sup>45</sup> Ray Tiernan, "Report: Yahoo-Microsoft Investor Overlap Supports A Deal," *Barron's*(2008), <http://blogs.barrons.com/techtraderdaily/2008/02/15/report-yahoo-microsoft-investor-overlap-supports-a-deal/>.

<sup>46</sup> Ibid.

Moreover, the discussion pointed to the fact that institutional investors may behave in a manner akin to that of a dominant shareholder under the traditional analysis of diffused versus concentrated ownership structures in the scholarship. Finally, the observations shed doubt on the extent to which institutional investors provide voice to all shareholders.

## V. REGULATORY IMPLICATIONS OF INSTITUTIONAL INVESTORS AS BLOCKHOLDERS

The thrust of this chapter is that ownership patterns within a given economy matter from a regulatory standpoint for corporate governance initiatives. Observing changes in the landscape subject to this regulation is paramount if such initiatives are to have a positive impact (and, therefore, social utility) rather than negative or neutral impact. This is the case whether we approach corporate governance from a domestic or international perspective.<sup>47</sup> I will explore the significance of these statements in the context of the subject of this chapter – institutional investors.

It has been noted that “[i]n its broadest sense, corporate governance is concerned with holding the balance between economic and social goals and between individuals and communal goals. ... The aim is to align as nearly as possible the interests of individuals, of corporations, and

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<sup>47</sup> Stijn Claessens, "Corporate Governance and Development," *Focus* 1(2003), [http://www.gcgf.org/ifcext/cgf.nsf/AttachmentsByTitle/Focus\\_1\\_CG\\_and\\_Development/\\$FILE/Focus\\_1\\_Corp\\_Governance\\_and\\_Development.pdf](http://www.gcgf.org/ifcext/cgf.nsf/AttachmentsByTitle/Focus_1_CG_and_Development/$FILE/Focus_1_Corp_Governance_and_Development.pdf); Wymeersch, "Convergence."

of society.”<sup>48</sup> One way of achieving these goals is through the promotion of international corporate governance standards – standards that started as national codes and later became international guidelines.<sup>49</sup> Key players in the promotion of these standards are institutional investors.<sup>50</sup>

Institutional investors are instrumental in the introduction of codes of corporate governance. They produce their own codes of best corporate governance practices, which they encourage their portfolio firms to adopt. Institutional investors are also relied upon by governmental agencies to get their portfolio firms to adopt the codes recommended by these agencies.<sup>51</sup> As Peer Zumbansen observed, corporate governance regulation can be seen as “transnational and hybrid in nature.”<sup>52</sup>

The reliance on institutional investors poses a challenge to policy making. As noted at the outset of this chapter, American institutional investors are credited for the promotion of shareholder-oriented model of corporate law around the world, which, inter alia, includes the promotion of dispersed ownership as the optimal model for corporate ownership. In addition,

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<sup>48</sup> Adrian Cadbury, ""Forward" to Stijn Claessens, "Corporate Governance and Development", *Focus* 1(2003), [http://www.gcgf.org/ifcext/cgf.nsf/AttachmentsByTitle/Focus\\_1\\_CG\\_and\\_Development/\\$FILE/Focus\\_1\\_Corp\\_Governance\\_and\\_Development.pdf](http://www.gcgf.org/ifcext/cgf.nsf/AttachmentsByTitle/Focus_1_CG_and_Development/$FILE/Focus_1_Corp_Governance_and_Development.pdf).

<sup>49</sup> Ibid.

<sup>50</sup> Ibid., v-vi.

<sup>51</sup> Chris A. Mallin, *Corporate Governance*, vol. 2nd ed. (Oxford: Oxford University Press, 2007). 82-85.

<sup>52</sup> Peer Zumbansen, "Transnational Legal Pluralism," *CLPE Research Paper* ; v.6, no.1 (2010) ; RPS-01(2010), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1542907#](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1542907#).

institutional investors are also credited with the reduction of public distrust in large firms.<sup>53</sup> Yet, as we have seen in Part II of this chapter, institutional investors are the emerging blockholder in the American equity markets. This paradox presents a potential challenge to policymaking. The potential challenge stems from the treatment of institutional investors in the corporate governance literature. This potential challenge also represents the point where economic analysis and legal analysis yield different results and, as such, depart from one another.

From an economic analysis perspective, whether we view them as blockholders or as agents for the diffusion of ownership, institutional investors are a powerful financial actor in the capital markets. They hold out significant potential as instruments for bringing about improvements in corporate governance practices. That is, institutional investors, as blockholders and transnational agents, possess the power to introduce the requisite change at both the national and international levels. Yet, this change poses a potential conflict due to the legal treatment accorded to institutional investors.

The conflict may be due to institutional investors as the source of the change in corporate governance policies or practices. If the proposed change originates with the institutional investor, it does not automatically mean that it is for the benefit of all the shareholders of the corporation. Institutional investor's interests are not necessarily identical to those of other shareholders. If, on the other hand, the change originates from the state, the state may need to rely on institutional investors to promote compliance by portfolio firms with the proposed change. When the state does this, it does so based on the notion that institutional investors are powerful and influential blockholders in the markets.

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<sup>53</sup> See, e.g., Stephen Davis, "Mobilizing Ownership – The Civil Economy Agenda," *0.618...*, January 2005; Stimson, "Effects of Popular Ownership."

While there may not be conflict per se in this process, it does lead us to question the fundamentals of corporate laws in countries such as the US, where the notion of dispersed ownership as being characteristic of the ownership pattern in that country is still upheld. This, therefore, leads to the conclusion that by necessity (as a result of the realization that a distortion is introduced into the legal system by viewing the American capital markets as properly characterized as fragmented) the regulatory framework in the US needs to be updated in order to give regulatory recognition to the fact that the ownership pattern in the US is MOB and that the blockholder in these markets is the institutional investor.

We can take this a little further. By failing to recognize that MOB represents the appropriate ownership pattern in the US and by continuing to promote policy initiatives that are premised on the assumption that the ownership pattern in the US is diffused, it is feasible that policymakers are introducing a distortion into the regulatory system. This is because the two ownership patterns (i.e., diffused, on the one hand, and MOB, on the other) give rise to different results and, as such, require different regulatory treatment. Moreover, there is the possibility for the policymaker to introduce systemic risk into both the national and international financial systems.<sup>54</sup>

## VI. CONCLUSION

US markets have gravitated towards a corporate ownership model represented by MOB. This affords liquidity in the capital markets, on the one hand, and enhanced monitoring of corporate managers, on the other. Market forces facilitated the concentration of ownership in the hands of

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<sup>54</sup> Aviv Pichhadze, "Private Equity, Ownership, and Regulation," *Journal of Private Equity* 14, no. 1 (2010).



a class of shareholders – namely, the institutional investor, thereby transforming the American equity markets into a variant of the blockholder model.

From a policy perspective this trend and the resulting ownership model – MOB – are significant. Failure to recognize it and adjust policy thinking in order to accommodate it (via changing regulatory attitudes and policies) may result in the introduction of a system risk into the financial system. This is because of the important impact that ownership structures have on corporate and securities laws and regulation.

The urgency of this accommodation is for two fundamental reasons. First given that institutional investors, as blockholders, do not behave in the manner that is predicted in the scholarship (i.e., representing and advancing shareholder interests), policymakers need to update the fundamentals of corporate and securities regulations to reflect fully the realities created by institutional investors as blockholders. Second, the important role of institutional investors in the international arena also mandates such an update in order to reduce the introduction of systemic risk into the financial system, both global and domestic) resulting from the reliance on institutional investors for the promotion of improved corporate governance. Such regulatory rethinking is important in the context of developed nations, but it is imperative for developing nations that rely on the leadership of developed nations to improve their corporate sectors and overall financial and economic viability and stability.

## CHAPTER 4, PRIVATE EQUITY, OWNERSHIP, AND REGULATION\*

I show that private equity transactions (i) illustrate market-driven reactions to inefficient equity markets that result from the diffusion of equity ownership in the public firm and (ii) form part of a larger market trend towards the market oriented blockholder model – a hybrid ownership structure that offers the benefits of monitoring associated with concentrated ownership along with the benefits of promoting liquid and efficient capital markets associated with diffused ownership. The analysis also explores the regulatory implications of the trend. In particular, I observe that policymakers display lack of awareness of the trend. Consequently, policymakers face the hazard (i) of amplifying embedded distortions within the US securities regulatory framework and (ii) of introducing what I call regulatory systemic risk into the framework.

### I. INTRODUCTION

Private equity (PE) and leveraged buyout (LBO) transactions (collectively “PE”) experienced an accelerated growth during the first decade of the 21st-century. Prior to the recent economic slowdown, evidence shows that PE has become an important source of capital in the global financial system with a total global deal value of US\$2.7 trillion between 2001 and 2007.<sup>1</sup> The evidence also shows that PE, which was mainly confined to the US during the 1980s, has

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\* This chapter appeared as Pichhadze, Aviv, 2010. “Private Equity, Ownership, and Regulation,” *Journal of Private Equity*, 14:1, 17.

<sup>1</sup> Lerner and Gurung, *Globalization of Alternative Investments 1*.

achieved global acceptance and that, in fact, the majority of the transactions are occurring outside of the US.<sup>2</sup>

Despite its apparent success, PE has experienced a slowdown during the recent economic crisis, leading some to question: “[i]s private equity solely an exercise of financial engineering or is it an ownership model capable of producing sustainable improvement in business? This is an important question as policy-makers address the question of a new financial architecture for a world in distress.”<sup>3</sup>

This chapter examines the role of PE as an ownership model and its significance to corporate governance. More particularly, building on the analysis performed by Pichhadze,<sup>4</sup> which showed that the US equity markets have been evolving towards the Market Oriented Blockholder Model (MOBM), the chapter seeks to advance two ideas. First, I propose that PE transactions are part of a larger trend in the US capital markets – one that is moving towards a stable and efficient state of corporate ownership which affords both (i) liquidity and efficiency and (ii) improved monitoring of management. Accordingly, PE is viewed as an extreme market reaction to inefficiencies that result from diffused ownership. From this perspective, PE plays a constructive role in the capital markets. Second, I draw attention to policy implications of the trend towards the MOBM. I propose that the regulatory failure to recognize the trend amplifies structural imbalances currently embedded in the securities regulatory framework in the US.

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<sup>2</sup> Ibid.

<sup>3</sup> ———, eds., *Globalization of Alternative Investments Working Papers Volume 2: The Global Economic Impact of Private Equity Report 2009* (New York, NY: World Economic Forum USA Inc., 2009).

<sup>4</sup> Pichhadze, "Market Oriented Blockholder Model."

## **II. PRIVATE EQUITY AND THE MARKET ORIENTED BLOCKHOLDER MODEL**

In this section, I propose that PE is part of an evolutionary trend in the US capital markets leading to the MOBM. As such, the question for policymakers is one of recognizing the trend and recognizing its implications for policy-making. To understand this claim, however, we must first examine the nature of PE and place these transactions in the larger context of the capital markets.

### **A. THE MARKET ORIENTED BLOCKHOLDER MODEL**

In the US, as the markets matured and grew in complexity, they have been evolving towards the MOBM. According to Pichhadze,<sup>5</sup> the MOBM is a hybrid ownership structure featuring a blockholder mode of ownership<sup>6</sup> that works with market mechanism (e.g., takeovers).

Admittedly, this observation is distinct from the general wisdom in the corporate governance literature, which holds that the ownership pattern in the US is properly understood as dispersed. Nevertheless, an evolutionary analysis of the equity markets reveals that the American

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<sup>5</sup> Ibid.

<sup>6</sup> The spectrum of public firm ownership can be divided into three clusters: (i) concentrated ownership (ownership concentration  $\geq 50.1\%$ ); (ii) blockholder ownership ( $5\% \leq$  ownership concentration  $\leq 50\%$ ); and (iii) dispersed ownership (ownership concentration  $< 5\%$ ). The choice of the 5% threshold is based on the disclosure filing requirements under s. 13(d), Securities Exchange Act of 1934, 15 U.S.C.A. Ch. 2B, that requires, inter alia, disclosure of beneficial ownership of 5% or more by any person of the outstanding shares of a firm's securities subject to Securities Exchange Act. While the above are used as a general guide, these lines of demarcation are fluid and are subject to change from one firm to another based on factors such as size of the firm and shareholdings of individual investors.

equity markets have gone through three stages of development, leading to the trend towards the MOBM.<sup>7</sup> It is worth noting that a similar three-stage development has also been observed in the context of the UK.<sup>8</sup>

During the early stages of the capital markets, ownership was concentrated in the hands of industrial elites. This was followed by the fragmentation of ownership in America's largest firms during the first half of the 20<sup>th</sup> century as corporations sought to raise capital from a growing pool of investors. This observation is largely associated with Berle and Means,<sup>9</sup> who were principally concerned with the power of large corporations.<sup>10</sup> Large firms accounted for approximately 23% of the public firms in their study. The remaining firms displayed blockholder ownership patterns.<sup>11</sup> As such, ownership during this second stage can be said to be "dispersed" to the extent that one confines the observation to these large firms.

Throughout the second half of the 20<sup>th</sup> century, the ownership of public corporate equity began to re-concentrate into the hands of institutional investors; thereby institutionalizing the American securities markets.<sup>12</sup> The institutionalization of the markets was encouraged by the US government, in part, as a response to changing socio-economic demands and needs,<sup>13</sup> and the process continues to the present day. The transformation in equity ownership from industrial

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<sup>7</sup> Pichhadze, "Market Oriented Blockholder Model."

<sup>8</sup> Davies, *Gower & Davies*, 7th.

<sup>9</sup> Berle and Means, *Modern Corporation*.

<sup>10</sup> Tsuk, "From Pluralism to Individualism."

<sup>11</sup> Berle and Means, *Modern Corporation*: 27.

<sup>12</sup> Cohen, "An Address by Manuel F. Cohen, Chairman, Securities and Exchange Commission, before the American Bankers Association."

<sup>13</sup> Naess, "Changing Patterns."

capitalism to financial capitalism paved the way for the movement towards the MOBM, which features institutional investors as blockholders.

The findings of Brancato and Rabimov<sup>14</sup> illustrate the extent of the institutionalization in the US markets. For example, they show that total institutional assets increased from \$2.7 trillion in 1980 to \$27.1 trillion in 2006. Total institutional holdings increased from \$8.7 billion in 1950 (or 6.1% of total equity markets) to \$12.9 trillion in 2006 (or 66.3% of total equity markets). In addition, institutional investors have increased their holdings in America's 1000 largest firms from 46.6% in 1987 to 76.4% in 2007.

In relation to America's 25 largest corporations (ranked by market capitalization as of December 31, 2007), Brancato and Rabimov<sup>15</sup> observed that these firms have a total institutional average holding ranging from a low of 52.9% in Exxon Mobil to a high of 85.4% in AIG. Of these 25 firms, 15 had at least one blockholder (i.e., investor owning 5% or more of the firm's outstanding shares). This list of 15 firms also includes AT&T, which Berle and Means used as their example of a dispersed giant corporation – indicating the change in the character of ownership in America's largest firms since Berle and Means published their widely cited study. In six of the largest 25 firms the largest investor held near blockholder levels (i.e., in the 4-5% range).

No less insightful is the observation made by others that “while there are many institutional investors, holdings are, in fact, concentrated in the hands of a relatively small number of the very largest institutional investors. For example, in the USA, the 100 largest fiduciary institutions hold fully 52 per cent of *all* publicly held equity” [emphasis in the

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<sup>14</sup> Brancato and Rabimov, *2008 Report*.

<sup>15</sup> *Ibid.*

original].<sup>16</sup> Hence, not only is equity ownership concentrated in the hands of institutional investors, ownership is further concentrated within this class of investors.

While the growth (both in terms of size and influence) of institutional investors is well documented in the literature, Pichhadze<sup>17</sup> turns our attention to an interesting peculiarity: the working hypothesis in the literature treats the US as a diffused ownership economy. An example of the working hypothesis can be found in the following statement by Bebchuk and Roe: “[a]t present, publicly traded firms in the United States and the United Kingdom commonly have dispersed ownership.”<sup>18</sup> In turn, the working hypothesis affected, as we shall see below, the views and understanding of regulators and policymakers who assume that the ownership pattern in the typical American public firm is diffused.

The growth of institutional investors in the US has cemented the gravitation towards the MOBM – or the third stage of development in ownership patterns in the US. The MOBM, as we shall see below, can be thought of as representing the result of the need of market forces to create an environment that facilitates enhanced monitoring of corporate managers, while ensuring liquid and efficient markets. In so doing, market forces have been facilitating the development of a variant of the blockholder model – a blockholder model that utilizes market mechanisms. This stands in contrast to other blockholder models discussed in the literature, which, generally, are said to exhibit a weak market for corporate control.<sup>19</sup>

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<sup>16</sup> Hawley and Williams, "Universal Owners," 415.

<sup>17</sup> Pichhadze, "Market Oriented Blockholder Model," 71-72.

<sup>18</sup> Bebchuk and Roe, "Path Dependence," 133.

<sup>19</sup> See, e.g., Bebchuk and Hamdani, "Elusive Quest."

## **B. PRIVATE EQUITY AS AN OWNERSHIP MODEL AND ITS ROLE IN THE TREND TOWARDS THE MOBM**

Jensen argued that PE introduces a new model for corporate ownership. This is because it resolves “the central weakness of the public corporation – the conflict between owners and managers over the control and use of corporate resources.”<sup>20</sup> As he noted elsewhere, “under the LBO or private equity governance system, the performance of the operating companies and their top managements is overseen by much smaller boards that consist mainly of the firm’s largest investors – other than the CEO, there are typically no insiders ... .”<sup>21</sup>

Accordingly, the PE model is said to be superior to the public firm because it offers (i) improved corporate governance, (ii) ownership that is concentrated in the hands of active owners or investors (accompanied by strong managerial incentives), and (iii) efficient capital structure. While PE can be described as representing a new model, it does “borrow several of the central governance features of venture capital firms.”<sup>22</sup>

The antecedent to the modern PE (i.e., the venture capital model) existed in the US during the turn of the 20<sup>th</sup> century. It combined active investors with the venture capital model. As a result, Jensen called the LBO wave “the rebirth of ‘active investors.’ By active investors I mean investors who hold large equity or debt positions, sit on boards of directors, monitor and sometimes dismiss management, are involved with the long-term strategic direction of the

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<sup>20</sup> Jensen, "Eclipse," 61.

<sup>21</sup> JACF, "Morgan Stanley Roundtable 2006," 13.

<sup>22</sup> Stern, Stewart, and Chew, "EVA," 146.



companies they invest in, and sometimes manage the companies themselves.”<sup>23</sup> These active investors defined American approaches to investment oversight.<sup>24</sup>

During the 20<sup>th</sup> century, active investors in the US “disappeared largely as a result of populist laws and regulations approved in the wake of the Great Depression.”<sup>25</sup> The causes that led to the disappearance of the active investor during the early stages of the capital markets also resulted in the fragmentation of ownership in public firms.

This was observed by Roe,<sup>26</sup> who notes that the corporate ownership model at the turn of the 20th century (i.e., the venture capital model) was not adopted as the preferred ownership model for corporate America as a result of populist laws and interest group politics. These two factors (i.e., populist laws and politics) “played a key role in fragmenting stock ownership *beyond* what was required” [emphasis added].<sup>27</sup>

The fragmentation in public corporate ownership (in large firms in particular) provided, it has been argued, for an environment for active investors to, inter alia, perform a governance function by filling the ownership gap.<sup>28</sup> Here, governance function means the monitoring of corporate managers.

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<sup>23</sup> Jensen, "Eclipse," 65.

<sup>24</sup> Pound, "Raiders."

<sup>25</sup> Jensen, "Eclipse," 65.

<sup>26</sup> Mark J. Roe, "The Political Roots of American Corporate Finance," *Journal of Applied Corporate Finance* 9, no. 4 (1997).

<sup>27</sup> *Ibid.*, 8.

<sup>28</sup> Pound, "Raiders."

According to this view, when the ownership of a public firm becomes too fragmented such that (i) the firm experiences a reduction in the effective monitoring of the firm's management, and (ii) such reduced monitoring results in the introduction of inefficiencies to the firm, then (iii) market mechanisms, such as takeover activity, introduce into the firm improved monitoring and enhanced efficiency by, among other things, concentrating, at least temporarily, the ownership of the firm.

The above process is not an episodic event but, rather, a recurring one.<sup>29</sup> More specifically, it appears to be a cyclical event that is part of the operation of the capital markets and is driven by market forces with the intention of eliminating inefficiencies in the marketplace and the firms operating within it. This is achieved through the provision of enhanced monitoring of listed firms while maintaining liquidity in the markets. Consequently, Pound observed, "[t]he ultimate result is never revolution, but rather evolution."<sup>30</sup>

This evolutionary process appears to be one that splices blockholder components onto a market system in an attempt of achieving a corporate governance structure that answers to two market needs: (i) the need for improved monitoring of corporate management (associated with concentrated ownership) and (ii) the need to have liquid and efficient capital markets (associated with dispersed ownership).

Under the traditional corporate governance analysis, these two features are often viewed as tradeoffs resulting from the choice between the dispersed ownership model and the concentrated model.<sup>31</sup> Under the conditions giving rise to the MOBM, however, these tradeoffs

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<sup>29</sup> Ibid.

<sup>30</sup> Ibid., 6.

<sup>31</sup> Coffee, "Future as History."

are transformed into complements. In addition, given that a feature of the model is the presence of a blockholder, the observation of the trend towards the MOBМ may point to the proposition that market forces are attempting to reduce the sub-optimality associated with diffused ownership.<sup>32</sup> Thus, market forces can be said to, in effect, be attempting to arrive at an ownership equilibrium that affords both liquidity and monitoring.

Market mechanisms assist in the promotion of this equilibrium and its maintenance over time. Maintenance is essential since the ownership equilibrium, once achieved, does not remain in a static state. Rather, it is a dynamic process that exhibits deviations from, and restoration to, the state. In this dynamic process, market mechanisms such as corporate control transactions (including PE) have an important role in restoring the equilibrium state when deviations from the equilibrium state occur.

In addition to transforming tradeoffs into complements, the MOBМ can also be said to represent a socially optimal ownership structure. Social optimality in the context of the corporation refers to the notion that the shareholders' representatives serve the shareholders' interest.<sup>33</sup> According to Grossman and Hart, social optimality in this context can be achieved in two ways (both of which are features of the MOBМ).

One way of ensuring that social welfare is met is through the monitoring of managers by shareholders. The problem, according to Grossman and Hart,<sup>34</sup> is that absent anyone owning sufficient stakes in the corporation, monitoring is left to market-mechanisms such as takeovers. Yet, as the discussion in this chapter has shown, market forces and socio-economic realities

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<sup>32</sup> Bebchuk and Zingales, "Ownership Structures."

<sup>33</sup> Grossman and Hart, "Theory of the Corporation."

<sup>34</sup> Ibid.

created a venue for the promotion of social optimality in the corporation. They have paved the way for the re-concentration of equity ownership into the hands of institutional investors, who have sufficient stake in the corporation and, therefore, an interest in monitoring corporate managers. Thus, markets forces appear to be reducing the costs associated with monitoring via voice.<sup>35</sup>

Active investors, institutional investors, and the takeover structures that their partnership produce to acquire control in companies (i.e., PE) appear, at a first glance, to be strange bedfellows. This is because active investors are said to have a negative image with both the public and the politicians.<sup>36</sup> On the other hand, institutional investors (i) enjoy, generally, the favor of the public, (ii) are viewed as part of the democratization of the public firm – as they are viewed as being the agents for the diffusion of the ownership of the public firm,<sup>37</sup> and (iii) are viewed as the champions of shareholder rights and improved corporate citizenship.<sup>38</sup>

Despite this curious marriage between institutional investors and active investors, Holmstrom and Kaplan<sup>39</sup> observed that the institutionalization of the American equity markets played a key role in the emergence of the takeover wave in the 1980s. Thus, the need for (i) increased returns on investment and (ii) liquidity for their equity holdings drive the institutional investors to PE; whereas the need for large pools of capital drives PE to institutional investors.

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<sup>35</sup> Simon Deakin et al., "Anglo-American Corporate Governance and the Employment Relationship: A Case to Answer?," *Socio-Economic Review* 4, no. 1 (2006).

<sup>36</sup> JACF, "Morgan Stanley Roundtable 2006.;" Pound, "Raiders."

<sup>37</sup> Carver, "Diffusion of Ownership.;" Hansmann and Kraakman, "End of History."

<sup>38</sup> ———, "End of History."

<sup>39</sup> Holmstrom and Kaplan, "Corporate Governance," 132.

### **C. AUTONOMOUS ADAPTABILITY**

The process of filling the ownership gap by market forces and the trend towards the MOBM represents what Williamson<sup>40</sup> describes as Hayek's autonomous adaptation. As Williamson explained, "adaptation is the central problem of economic organization. Hayek focused on the adaptations of economic actors who adjust spontaneously to changes in the market. ... the marvel of the market resides in 'how little the individual participants need to know to be able to take the right actions.'"<sup>41</sup> Thus, when faced with the ownership gap during the early decades of the 20th century, as industrial capital was diminishing from the public markets landscape, market forces adapted to the departure of industrial capitalists by re-concentrating ownership into the hands of fiduciaries that were able to take up the task of a large owner. Market actors, however, did not need to have the conscious knowledge of this process.

### **III. REGULATORY IMPLICATIONS OF THE MOBM**

The failure to take note of the trend towards the MOBM in the literature had consequences for policy-making by amplifying embedded imbalances in the system. I first show the significance of regulatory recognition of the MOBM for the purposes of promoting efficiency in the securities markets. I then turn to describing the imbalances embedded in the regulatory framework, the manner in which they are amplified, and the regulatory consequences of such oversight.

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<sup>40</sup> Oliver E. Williamson, "The Economics of Governance," *American Economic Review* 95, no. 2 (2005).

<sup>41</sup> *Ibid.*, 4.

## A. CONSCIOUSLY COORDINATED ADAPTATION

First introduced in 1998 by the International Organization of Securities Commissions (IOSCO), the *Principles of Securities Regulation*<sup>42</sup> provide for a general framework for the regulation of the securities markets and their participants to meet three objectives: (i) investor protection, (ii) ensuring fair, efficient, and transparent markets, and (iii) the reduction of systemic risk. According to IOSCO “the Regulator should review the particular way in which securities regulation is carried out because the markets themselves are in a constant state of development and the content of regulation also must change if it is to facilitate and properly regulate these evolving markets.”<sup>43</sup>

The requirement for regular monitoring of market trends and the adjustment of regulation to meet the demands created by changing market dynamics identified by IOSCO corresponds with Williamson’s second type of adaptation – a consciously coordinated adaptation, which is accomplished in a conscious, deliberate and purposeful manner through the use of administration.<sup>44</sup> Administration in the context of the capital markets refers to securities regulators such as the Securities and Exchange Commission (SEC). According to Williamson, in order to promote efficiency in the markets this regulatory type of adaptation should supplement the trend towards the MOBM that reflects autonomous adaptation by market forces.

When we examine the regulatory framework of the securities markets in the US as a whole, however, it becomes apparent that consciously coordinated adaptation is absent. This is

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<sup>42</sup> IOSCO, "Methodology for Assessing Implementation of The IOSCO Objectives and Principles of Securities Regulation, IOSCO Report," (International Organization of Securities Commissions, 2008).

<sup>43</sup> *Ibid.*, 6.

<sup>44</sup> Williamson, "Economics of Governance."

best observed in the context of the legal system's failure to update some of its definitions vis-à-vis ownership patterns in the US. More particularly, while actors in the capital markets have recognized the growing importance of institutional investors in the capital markets as financial blockholders (both nationally and internationally), the legal system, though facilitating this important development and taking note of it, has not yet updated its basic definitions to take note of this process. Such a failure to update the basic fundamentals of the regulatory framework also poses a hazard to the integrity of the regulatory framework. This hazard is referred to in this chapter as regulatory systemic risk.

## **B. IMBALANCE AND RISK IN THE REGULATORY FRAMEWORK**

Suppose we treat the regulatory framework of the securities markets as a system (i.e., an aggregate of policies and regulations forming a connected or complex whole), systemic risk, then, is a problem that pertains to the system. In this context, Schapiro, Chair of the SEC, recently explained that the regulatory framework, or the system, is vulnerable to two types of systemic risk: (i) near-term systemic risk and (ii) long-term systemic risk.<sup>45</sup>

Near-term systemic risk results from seizures or cascading failures that threaten the stability of the financial markets. Factors that may create near-term systematic risk include, for example, catastrophic failure of major players (in the banking sector) and the inability to process or validate trades (in the securities industry). Longer-term systemic risk results from the unintentional bias towards larger institutions at the expense of smaller participants.

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<sup>45</sup> Mary L. Schapiro, "Testimony Concerning Regulation of Systemic Risk Before the United States Senate Committee on Banking, Housing and Urban Affairs (July 23, 2009)," US Securities and Exchange Commission, <http://www.sec.gov/news/testimony/2009/ts072309mls.htm>.

To these two types of systemic risk, one should add another type of risk – regulatory systematic risk. This type of risk arises when regulation fails to properly reflect, and respond to, market realities – that is, a risk that arises in cases where there is misalignment between regulation and market realities. This results in regulatory gaps, which over time become embedded in the regulatory framework that, in turn, introduce structural imbalance into the overall regulatory framework. In the context of the corporate governance regulatory framework in the US, regulatory systemic risk arises due to the distorted view in relation to public equity ownership.

A noteworthy example of regulatory systemic risk can be found in the proxy rules, found in s. 14 of the Securities Exchange Act of 1934. It has been observed that these rules “derive directly from the Berle-Means description of the public corporation and the belief that managerialism represented a threat to public shareholders.”<sup>46</sup> Implicit in this observation is the notion that the typical American firm at the time the proxy rules were introduced was characterized by diffused ownership.

As noted earlier, however, approximately 77% of the firms in the Berle and Means<sup>47</sup> study were characterized as having a blockholder mode of ownership. Consequently, the extension of Berle and Means’ observation in relation to a fraction (or 23%) of the firms in their study to cover the whole body of firms in the securities markets introduced imbalance or distortion into the regulatory framework. The distortion is that while the regulator should have focused on the blockholder-minority shareholder type tension – relevant to the majority of the

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<sup>46</sup> Sargent and Honabach, "Proxy Regulation and the Corporation Governance Debate, § 1:1 Introduction."

<sup>47</sup> Berle and Means, *Modern Corporation*.



listed firms at the time, it focused on the shareholder-manager type of tension – relevant to minority of the firms at the time.

Over the years since the introduction of the proxy rules, the character of ownership has changed. Individual blockholders, who controlled 77% of the firms in the Berle and Means study, were replaced by institutional investors, who held over 74% of America's 1000 largest public firms in 2007. Yet, we see that the underlying premise of the proxy rules as being based on the Berle-Means Corporation has become embedded in the regulatory framework and is carried forward to the present day.

This regulatory approach is supported by academic thinking which holds that, although fragmented ownership is mainly characteristic of a fraction of all the listed firms, “[t]he largest companies are very much giants among their corporate brethren. As a result, a separation between ownership and control remains an appropriate reference point.”<sup>48</sup> This view led regulators to the erroneous belief that their focus should be dictated by the size of the regulated entity. This is despite the fact that even this class of corporations has been experiencing a re-concentration of ownership into the hands of institutional investors and, consequently, even these large firms do not neatly qualify as the Berle-Means Corporation.

The most recent reiteration of this can be seen in a recent proposal by the SEC (*Facilitating Shareholder Director Nominations*) (the “Proposal”), which is meant to make boards of directors accountable to shareholder interests.<sup>49</sup> The purpose of introducing the Proposal is not to engage in the discourse on shareholder voting rights and/or the merits of the Proposal, but rather to highlight the embeddedness of the distortion described above vis-à-vis

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<sup>48</sup> Cheffins and Bank, "Is Berle a Myth," 467.

<sup>49</sup> 17 CFR Parts 200, 232, 240, 249 and 274 [Release Nos. 33-904660089; IC-28765; File No. S7-10-09], at 29025.

ownership within the regulatory framework and the risks associated with the failure to realize and recognize the distortion.

While the Proposal is cushioned in language that is embrative of all shareholders (in allowing them to participate in the director nomination process), its threshold requirements are such that only a select group of shareholders can meet these requirements (consisting mainly of institutional investors). Accordingly, the overall effect of the Proposal is the empowerment of institutional investors. In addition, the Proposal assumes that the typical public firm in the US is the Berle-Means Corporation.

Accordingly, by assuming that the tension to be resolved by regulation is the shareholder-manger type tension (associated with atomistic ownership), which is concerned with the protection of shareholders from management abuses, the Proposal fails to notice (and address) the real tension: the minority shareholder-blockholder type tension (associated with block ownership), which is concerned with the interests of non-blockholders. Recognition of the minority shareholder-blockholder tension assumes greater regulatory importance once we factor in the claim that shareholders are a heterogeneous group with different interests.<sup>50</sup> This is because regulatory initiatives that may be suited for financial blockholders may not necessarily address the concerns of smaller retail investors.

While the above discussion focused on the proxy rules in the US, a student of the area will realize that the distortion vis-à-vis ownership patterns highlighted above extends to other areas of the regulatory framework. This is because ownership affects several key governance arrangements of which the proxy rules are only part. These arrangements include: (i) takeovers

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<sup>50</sup> Anabtawi, "Some Skepticism about Shareholder Power."; Anabtawi and Stout, "Fiduciary Duties."

and defensive measures adopted by firms to thwart such activity, (ii) conflict of interest rules and related party rules, (iii) significant corporate action and disclosure rules, and (iv) director independence.<sup>51</sup> Hence, the spectrum of areas of the law impacted by the distortion vis-à-vis ownership patterns serves to illustrate the heightened hazard for the regulatory systemic risk.

#### IV. CONCLUSION

PE forms part of a larger trend in which market forces are combining (i) blockholder features with (ii) market system features in order to arrive at a corporate ownership structure that affords both liquidity and efficiency in the markets, on the one hand, and enhanced monitoring of management, on the other. This ownership structure is the MOBM – a hybrid ownership structure that features block holdings that work with market mechanisms such as takeovers.

Diffused ownership and the MOBM give rise to different regulatory opportunities and challenges. Thus, in order to (i) infuse efficiency into the capital markets, (ii) reduce regulatory systemic risk, and (iii) improve shareholder protection, the market trend toward the MOBM needs to be supplemented by regulatory recognition. This will assist regulators in removing imbalances currently embedded within the regulatory framework. This requires taking positive steps to address areas of the regulatory framework impacted by ownership patterns.

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<sup>51</sup> Bebchuk and Hamdani, "Elusive Quest."; Kraakman, *Anatomy of Corporate Law*.

## CHAPTER 5, REGULATORY SYSTEMIC RISK IN US SECURITIES

### REGULATION\*

The concept of regulatory systemic risk – a long-term imbalance, resulting from the misalignment between regulatory initiatives and market realities, that impacts multiple areas of the regulatory framework – is developed in the context of US securities regulation. The discussion offers two theses: one descriptive and the other normative. Descriptively, drawing on institutional approaches to the study of regulation, I show how regulatory systemic risk emerges in the US securities regulatory framework. The issue is examined by looking at s. 971, Proxy Access, of the Dodd-Frank Act. Normatively, the discussion highlights the failure of the Dodd-Frank Act to mitigate regulatory systemic risk.

#### I. INTRODUCTION

The recent economic crisis, which has been attributed to the complexity of the financial markets,<sup>1</sup> resulted in heightened public and regulatory interest in increased regulation of the financial markets and the extension of regulation into new areas.<sup>2</sup> In the US, the regulatory

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<sup>1</sup> See, e.g., Steven L. Schwarcz, "Leverhulme Lecture: The Global Financial Crisis and Systemic Risk," (2010), <http://ssrn.com/abstract=1707051>.

<sup>2</sup> For a synopsis of events leading to the financial crisis and some of the initiatives adopted in response in various countries, see, e.g., IBA Task Force on the Financial Crisis IBA's Task Force on the Financial Crisis, "A Survey."

response to the crisis resulted, among other things, in the introduction of what has been referred to as the greatest legislative regulatory change to US financial regulation since the 1930s:<sup>3</sup> the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Dodd-Frank Act), which was adopted in July 2010 to address a number of shortcomings in the financial regulatory framework in the US prior to the crisis.

The Dodd-Frank Act addresses, among other things, corporate governance concerns and other improvements to the securities regulatory framework with the objective of reducing exposure and vulnerability to systemic risk in the regulatory framework governing the securities markets. The reforms include revisions to the proxy rules in the US, which are found in s. 14(a) of the Securities Exchange Act of 1934.<sup>4</sup> These revisions, which are found in s. 971 of the Dodd-Frank Act and are referred to as “proxy access”, are said to enable shareholders to have greater voice in corporate democracy during the aftermath of the crisis.<sup>5</sup>

The nature of the nexus between proxy access, regulatory efficiency, and, consequently, the reduction of systemic risk in the regulatory framework governing the securities markets, however, was recently put into question.<sup>6</sup> More particularly, Pichhadze argued that the SEC Proxy Access Rule illustrates, and further facilitates, regulatory systemic risk – a risk which

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<sup>3</sup> Ibid.

<sup>4</sup> 15 U.S.C. 78n(a). The revisions were introduced by the Securities Exchange Commission as a rule *Facilitating Shareholder Director Nominations*, 17 CFR Parts 200, 232, 240 and 249 (SEC Proxy Access Rule).

<sup>5</sup> Senate Committee on Banking Housing and Urban Affairs, "Report of the Senate Committee on Banking, Housing, and Urban Affairs regarding The Restoring American Financial Stability Act of 2010," (United States Senate, 2010), 36.

<sup>6</sup> Pichhadze, "Private Equity."

arises from long-term imbalances that result from regulatory initiatives that are premised on a distorted understanding of market realities.<sup>7</sup>

In this chapter I develop the concept of regulatory systemic risk in the context of the US securities regulatory framework using socio-legal and law and economics approaches. Part II highlights inconsistency in the policy objectives found in the Dodd-Frank Act vis-à-vis regulatory purpose. Part III develops the concept of regulatory systemic risk. Part IV illustrates the concept of regulatory systemic risk in the context of proxy rules regulation in the US. Part V provides some concluding remarks.

## **II. PROXY ACCESS: LEGISLATIVE PURPOSE AND INCONSISTENCIES**

The reforms adopted in the US in response to the recent financial crisis are intended to promote financial stability in the US through numerous measures designed to improve accountability, resiliency, and transparency in the financial markets.<sup>8</sup> Underscoring many of the reforms are the need to correct market failures that led to the crisis, on the one hand, and the need to restore consumer and investor protection (and thereby confidence) in the financial markets, on the other.

Framed on public interest grounds, the reforms are said to be justified on the basis that the markets failed to address negative externalities or imperfections (such as systemic risk) that led to recent failures.<sup>9</sup> That is, government regulation, according to this argument, can do what

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<sup>7</sup> Ibid.

<sup>8</sup> Senate Committee on Banking Housing and Urban Affairs, "Report of the Senate Committee on Banking, Housing, and Urban Affairs regarding The Restoring American Financial Stability Act of 2010," 1.

<sup>9</sup> Schwarcz, for example, noted that without regulation, externalities caused by systemic risk would not be prevented. Schwarcz, "Leverhulme Lecture: The Global Financial Crisis and Systemic Risk". 4. For discussion on

the markets cannot. Thus, we see that the Dodd-Frank Act deals, for example, with matters relating to systemic risk resulting from financial intermediaries, non-financial intermediaries that may present systemic burden on the financial system, and certain financial instruments.

The Dodd-Frank Act, however, also introduced into legislation matters that were not directly linked to the financial crisis and, as such, did not directly relate to externalities leading to market failure (such as systemic risk). In particular, s. 971, Proxy Access, of the Dodd-Frank Act, allows shareholders to nominate board nominees on the company proxy. The justification for this addition was to allow shareholders, as the owners of the corporation, to have greater voice in the affairs of the corporation.<sup>10</sup>

Section 971, Proxy Access, was introduced by Senator Schumer (D) and gives the Securities and Exchange Commission (SEC) wide latitude in setting the terms of proxy access.<sup>11</sup> In doing so, the Dodd-Frank Act precludes arguments that the SEC does not have rule-making authority vis-à-vis proxy access.<sup>12</sup>

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public interest theories of regulation see, e.g., Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (Oxford: Hart Publishing, 2004)..

<sup>10</sup> Senate Committee on Banking Housing and Urban Affairs, "Report of the Senate Committee on Banking, Housing, and Urban Affairs regarding The Restoring American Financial Stability Act of 2010," 146.

<sup>11</sup> Ibid.

<sup>12</sup> John T. Bostelman, Robert E. Buckholz, and Marc Trevino, *Public Company Deskbook*, (New York, N.Y.: Practising Law Institute, 2010). For a brief history of the proxy access debate, see, e.g., Larcker and Tayan, "Proxy Access: A Sheep, or Wolf in Sheep's Clothing?".

Yet, it can be argued that this part of the Dodd-Frank Act reflects a private interest approach to regulation.<sup>13</sup> As such, this part of the Act stands in contrast, in terms of regulatory purpose, to other areas of the Dodd-Frank Act that have a public interest element to them. More particularly, it can be argued that s. 971 of the Dodd-Frank Act and the SEC Proxy Access Rule represent the cumulative result of various interest groups pressing both the SEC and the legislators for the adoption of the proxy access rules, thereby giving an interest group politics taint to the legislation.<sup>14</sup>

The interest group taint appears to arise from the “battle lines”<sup>15</sup> in the debate over the introduction of the proxy access legislation – lines that are reflected in the SEC. Such concerns appear to rest on three related observations. First, the Democratic Party is said to be allied with labor unions and public pension funds that represent the strongest supporting voice for the proxy access amendments, while corporate interests allied with the Republican Party oppose the legislation.<sup>16</sup> Second, The Democratic Party, through its control of the SEC, was pushing for the

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<sup>13</sup> For discussion on private interest theories of regulation see, e.g., Steven P. Croley, "Theories of Regulation: Incorporating the Administrative Process," *Columbia Law Review* 98, no. 1 (1998).

<sup>14</sup> See, e.g., Grundfest, "SEC's Proposed Proxy Access Rules." Grundfest argued (at 365) that proxy access generates “megaphone externalities” by drawing attention to union and pension fund causes even if their nominees have little chance to win nomination). Grundfest also identified internal inconsistencies within the SEC Proxy Access Rule but a discussion of this is beyond the scope and purpose of this chapter.

<sup>15</sup> *Ibid.*, 378.

<sup>16</sup> *Ibid.*



proxy access reforms since it gained control of the organization.<sup>17</sup> Finally, the Democratic Party is credited with the introduction of s. 971 into the Dodd-Frank Act.

While one may argue that interest group politics and their impact on legislation are a feature of the political system, the inclusion of the proxy access rule in detailed reform legislation such as the Dodd-Frank Act raises an ancillary concern. It is that s. 971 of the Dodd-Frank Act and the SEC Proxy Access Rule exemplify regulatory systemic risk, or systemic risk which originates from the regulator, within the regulatory framework governing the securities markets.<sup>18</sup>

### **III. REGULATORY GAPS AND RISK**

Regulatory systemic risk arises from gaps within the regulatory framework resulting from the misalignment between policy initiatives and market realities. Consequently, distortions or imbalance is introduced into, and embedded within, the regulatory framework and impacts multiple areas of the framework. The proxy access rules provide an illustration of this type of hazard. Prior to describing how the proxy regulatory scheme in the US gives rise to this type of risk, however, the discussion will elaborate on the concept of systemic risk as used in this chapter.

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<sup>17</sup> For example, Schapiro, Chair of the SEC, has expressed her commitment to the introduction of the SEC Proxy Access Rule in the past: "Speaking for myself ... I intend to make proxy access – meaningful opportunities for a company's owners to nominate its directors – a critical part of the Commission's agenda in the coming months." Schapiro, "Testimony Concerning Enhancing Investor Protection 2009".

<sup>18</sup> Pichhadze, "Private Equity."

## A. TRADITIONAL APPROACHES TO SYSTEMIC RISK

Wymeersch argued that “it is widely accepted that [systemic risk] is a flexible notion, difficult to capture in one sentence, and changing depending on time and context ... and it is probably better that we do not define it too clearly.”<sup>19</sup> Indeed, the drafters of the Dodd-Frank Act appear to have followed this advice and have not defined the term.

Despite the need for what appears to be regulatory flexibility vis-à-vis the meaning of systemic risk, we may, nonetheless, want to define of the term. Schwarcz proposes a broad definition of systemic risk that is inclusive of both market and financial failures:

A common factor in the various definitions of systemic risk is that a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences – sometimes referred to as a domino effect. These consequences could include (a chain of) financial institutions and/or market failures. Less dramatically, these consequences might include (a chain of) significant losses to financial institutions or substantial financial-market price volatility. In either case, the consequences impact financial institutions, market, or both.<sup>20</sup>

While Schwarcz provides a definition of the common understanding of what constitutes systemic risk, it would be valuable to add a regulatory perspective of systemic risk. More

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<sup>19</sup> Eddy Wymeersch, “What systemic risks may concern specific players/activities such as derivatives, CCPs and Hedge Funds? How to mitigate them?,” *Financial Law Institute Working Paper Series S&C 2010-02, 1*(2010), <http://www.law.ugent.be/fli/wps/showwps.php?wpsid=176>. Schwarcz, however, argued that the vagueness of the term begs for a definition. Steven L. Schwarcz, “Systemic Risk,” *Georgetown Law Journal* 97(2008).

<sup>20</sup> ———, “Systemic Risk.” See also Hudson Alastair Hudson, *The Law of Finance* (London: Thomson Reuters, 2009). 28-29.

particularly, it would be valuable to understand how the SEC perceives the term. The reason for this is based on the fact that the SEC is responsible for the regulation of the securities markets.

Schapiro, Chair of the SEC, offered a broader definition of systemic risk than Schwarcz. She distinguished between two types of systemic risk: (1) near-term systemic risk and (2) long-term systemic risk.<sup>21</sup> Near-term systemic risk results from seizures or cascading failures that threaten the stability of the financial markets. Factors that may contribute to near-term systematic risk include, for example, catastrophic failure of major players (in the banking sector) and the inability to process or validate trades (in the securities industry). Thus, we see that Schapiro's conception of what constitutes near-term systemic risk is similar to Schwarcz's definition of systemic risk. Longer-term systemic risk results from the unintentional bias towards larger institutions at the expense of smaller participants.

Schapiro drew a causal relationship between these two types of risk. Schapiro cautioned that in attempting to protect the financial system from near-term seizures, regulators can inadvertently introduce long-term imbalances into the regulatory system. To avoid such outcome, Schapiro suggested, *inter alia*, addressing "structural imbalances that facilitate the development of systemic risk by closing gaps in regulations ... ." <sup>22</sup> To meet this challenge adequately, we must first observe the structural regulatory imbalances and gaps currently embedded in the system.

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<sup>21</sup> Schapiro, "Testimony Concerning Regulation of Systemic Risk 2009".

<sup>22</sup> *Ibid.*

## **B. AN INSTITUTIONAL OR SYSTEMS APPROACH TO RISK**

To observe, realize, and understand the gaps within the securities regulatory framework in the US, we need some appreciation of the institutional dynamics within the regulatory framework. Systems theory provides appropriate analytical tool for our purposes.<sup>23</sup> Accordingly, treating the regulatory framework of the securities markets as a system (i.e., an aggregate of policies and regulations forming a connected or complex whole), systemic risk is a problem that pertains to the system (i.e., the regulatory framework). Adopting a systems approach to regulation offers a descriptive value to the analysis of the regulatory framework and the quest of achieving the desired outcomes.<sup>24</sup>

### **1. Features of a System**

Realizing that the regulatory framework operates as a system means that, like other social systems, it has several core features.<sup>25</sup> First, the system performs some function(s). Second, the system possesses the mechanisms required for achieving/performing its function(s), and these mechanisms can evolve over time. Third, the sustainability of the system is dependent on its ability to carry out its function(s) in a consistent and stable manner over time, which requires the sustainment of a constant framework for the mechanisms which it operates (i.e., operational closure).

Fourth, the achievement of operational closure can be complicated and challenged by influences that may be either external or internal to the system. Thus, while the system is closed to the extent that it seeks to preserve its internal integrity (i.e., the framework by which it

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<sup>23</sup> Jenny Stewart and Russell Ayres, "Systems Theory and Policy Practice: An Exploration," *Policy Sciences* 34, no. 1 (2001).

<sup>24</sup> *Ibid.*, 88.

<sup>25</sup> Luhmann, *Law As a Social System*; Teubner, *Law as an Autopoietic System*.

performs functions), it is open and vulnerable to influences from other systems (e.g., political and economic systems) and even changes within its own environment (i.e., the system is cognitively open).

Finally, as the system observes changes to, and instability in, its structural framework (be it due to internal or external factors), the system determines whether, and how, to respond. The system may decide to adapt to the change and evolve. It may do so through the process of self-reproduction (autopoiesis), whereby it evolves based on its existing framework. Alternatively, it may decide to preserve the status quo, and will apply its self-regulatory mechanisms (homeostasis or negative feedback) to restore its normal condition.

As the system evolves over time, autopoiesis and homeostasis work harmoniously to achieve evolutionary improvements in the system while maintaining the stability and integrity of the system as a whole. The decisions made by the system are also path-dependent.

## **2. Risk in the System**

Luhmann identified that the above features of the system serve to reduce systemic risk within the system.<sup>26</sup> The reduction of systemic risk is achieved through the stabilization of normative expectations. Yet, the ability of the law to stabilize normative expectations may be declining due to the temporalization of the law (i.e., the law is only valid until further notice).<sup>27</sup>

The problem of temporalization increases when legal norms are subject to internal or external errors. Example of internal errors is the presumed validity of certain facts that are later successfully challenged, which results in the reversal of decisions made based on the original

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<sup>26</sup> Nobles and Schiff, "Introduction," 48.

<sup>27</sup> *Ibid.*, 49.

facts. Example of external errors is the passing of legislation by the political system based on its construction of a social problem, only to pass new legislation when the problem is reformulated. The temporalization issue leads to awareness that the legal system may be itself be the source of risk.<sup>28</sup> According to Luhmann, the legal framework responds to this risk by learning and evolving.

Yet, what happens when the legal system fails to correct an observable error within the confines of its framework and, as a consequences, regulatory gaps are created and remain open (and may even widen)? That is, rather than engage the system's self-regulatory mechanism (i.e., negative-feedback) in response to laws that are no longer deemed to be good laws, the system perpetuates the error by replicating it throughout the system (i.e., the system exhibits positive-feedback), thereby leading to multiple equilibrium states, some of which may represent undesirable steady states.

The risk associated with such a process is that it may lead to instability in the legal system. Instability arises from the reduced certainty vis-à-vis expectations as a result of multiple equilibrium states.<sup>29</sup> This presents both a challenge and a hazard to the legal system – the purpose of which is to stabilize normative expectations. The problem is further compounded once the undesirable equilibrium state is locked-in or generates path dependency and, as a result, the error is perpetuated and embedded throughout the system.

According to Pichhadze,<sup>30</sup> this situation leads to regulatory systemic risk. Regulatory systemic risk arises where (1) policy initiatives do not align with market realities such that

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<sup>28</sup> Ibid.

<sup>29</sup> W. Brian Arthur, "Positive Feedbacks in the Economy," *Scientific American* 262, no. 2 (1990).

<sup>30</sup> Pichhadze, "Private Equity."

regulatory gaps are created, (2) these gaps do not receive regulatory attention and become embedded in the regulatory framework, and (3) the reach of the distortion(s) extends to multiple areas of the regulatory framework. Accordingly, we get imbalances of a long-term nature that are systemic to the regulatory framework or, phrased differently, we arrive at regulatory systemic risk.

### **3. Gaps and Imbalance Giving Rise to Regulatory Systemic Risk in the US Securities Regulatory Framework**

The regulatory assessment and treatment of public corporate ownership in the US provides for an example of an error that was introduced into the regulatory framework of the securities markets in the US when it was first established during the 1930s<sup>31</sup> – an error that is yet to be acknowledged and addressed by the regulator.

The SEC is charged with the administration of the regulatory framework of the securities markets in the US. In doing so, the SEC carries the responsibility of administering and enforcing the federal securities laws with the view of achieving the organization's tripartite mission of (1) protecting investors, (2) maintaining fair, orderly, and efficient markets, and (3) facilitating capital formation.<sup>32</sup> This is the function feature of the system.

The mechanisms through which the SEC carries out its function include the following administrative powers: (1) rule-making, (2) adjudication, (3) investigation, and (4) enforcement. It has been observed that SEC's enforcement powers have expanded significantly over the last

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<sup>31</sup> Ibid., 20-22.

<sup>32</sup> SEC, "The Investor's Advocate".

few decades, and that the only administrative authority it is lacking is the power to adjudicate disputes between individuals.<sup>33</sup>

The SEC has been able to carry out its functions in a relatively stable manner and achieve evolutionary improvements through interaction with other systems, such as the economic and political systems. Interestingly, however, it was also able to maintain gaps within its framework. These gaps represent errors in the framework and a significant hazard. The hazard results from the creation of multiple equilibrium states in the regulatory framework and, therefore, imbalance in the system.

For the purposes of the discussion in this chapter, the gaps originated in a misalignment between the real nature of public firm ownership at the time the proxy rules were first introduced in the US (i.e., displayed blockholder type of ownership) and the regulatory view of the nature of public ownership at the time (i.e., assumed atomistic or dispersed ownership). The regulatory understanding of the nature of public firm ownership was carried forward since that time and has become embedded in the framework thereby affecting multiple areas of the framework and, thus, becoming systemic.

#### **IV. SEC PROXY ACCESS: AN EXAMPLE OF REGULATORY SYSTEMIC RISK**

The SEC Proxy Rule serves to illustrate two deficiencies in the regulatory framework of the securities markets in the US. First, as already noted, there is evidence of regulatory systemic risk embedded in the framework. Second, it points to efficiency deficiencies in the framework.<sup>34</sup> To

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<sup>33</sup> Thomas Lee Hazen, "§ 1.4," in *The Law of Securities Regulation* (Westlaw, 2011).

<sup>34</sup> Pichhadze, "Private Equity."



understand this argument, we need to realize the nexus between public corporate ownership, on the one hand, and the proxy rules, on the other. In doing so, we also realize the timing for introduction of the error into the framework and the manner in which it was embedded into the system.

#### **A. INTRODUCTION OF THE PROXY RULES AND OF AN ERROR**

The proxy rules in the US are found in s. 14(a) of the Securities Exchange Act of 1934. The rules, in accord with the full disclosure scheme of the federal securities legislation, were designed to keep shareholders adequately informed about the public corporation's financial and other affairs so that they could exercise their voting rights in a meaningful manner.<sup>35</sup>

Sargent and Honabach observed that the "SEC's proxy rules can be seen as deriving directly from the Berle-Means description of the public corporation and the belief that managerialism represented a threat to public shareholders."<sup>36</sup> That is, the proxy rules were premised on the understanding that atomistic share ownership accurately reflected the state of public corporate ownership during the time the proxy rules were introduced. As such, the legislation sought to mitigate the shareholder-manager type tension that seeks to protect shareholders from abuses by management.

By internalizing the Berle and Means conception of the corporation as being characterized by atomistic ownership, those charged with introducing legislation and rules

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<sup>35</sup> Sargent and Honabach, "Proxy Regulation and the Corporation Governance Debate, § 1:1 Introduction."

<sup>36</sup> Ibid. Briefly stated, Berle and Means observed that by the early 1930s the wealth of corporate America was concentrated in the hands of that nation's largest corporations, and that these corporations have experienced the separation of ownership from control. Berle and Means, *Modern Corporation*.

committed an oversight that introduced an error into the regulatory framework of the securities markets and created an imbalance.<sup>37</sup>

Oversight stems from the fact that 77% of the public firms in the Berle and Means study were properly characterized as displaying blockholder modes of ownership, whereas atomistic ownership was only displayed in 23% of the firms. As such, regulatory emphasis should have been on addressing the minority shareholder-blockholder tension, which seeks to protect minority shareholders from abuses by larger shareholders or blockholders. By addressing the shareholder-manager tension that characterized the only 23% of the firms (though larger in size and market dominance than the other 77%) an imbalance was created in the framework.<sup>38</sup> Thus, giving rise to an error.

## **B. EMBEDDING AND AMPLIFYING THE IMBALANCE**

The foundation of the proxy rules, from an ownership perspective, did not change since its introduction (and is also reflected in the SEC Proxy Rule). This led some commentators to question the appropriateness of the rules to the current character of public corporate ownership.<sup>39</sup> Skepticism stems from the observation that, while the proxy rules are premised on the notion of atomistic ownership, the nature of the shareholder has changed from the retail investor to institutional investors.

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<sup>37</sup> Pichhadze, "Private Equity," 21.

<sup>38</sup> As Vagts observed, "[a] shift in corporate legal structure appropriate enough for the corporate giant might be burdensome or even disastrous for the intermediate concern as well as for the midget." Vagts, "Reforming the "Modern" Corporation," 32.

<sup>39</sup> Pichhadze, "Private Equity."; Sargent and Honabach, "Proxy Regulation and the Corporation Governance Debate, § 1:1 Introduction."

## 1. Autonomous Adaptation

The institutionalization<sup>40</sup> of the US markets (i.e., the transfer of equity ownership from retail investors to institutional investors) over the course of the second half of the 20<sup>th</sup> century resulted in the concentration of ownership into the hands of institutional investors and formed part of the trend towards the Market Oriented Blockholder (MOBM) – a hybrid corporate ownership structure that features a blockholder mode of ownership that works with market mechanisms such as takeovers.<sup>41</sup> Pichhadze<sup>42</sup> argued that this trend represents what Williamson referred to as autonomous adaptation by market forces to the changing character of ownership (or the spontaneous adaptation by market actors to changes in the markets).<sup>43</sup>

In applying the concept of autonomous adaptation to the markets, Pichhadze observed that, in response to an ownership gap that was created during the early decades of the 20<sup>th</sup> century, as a result of the diminishing role played by industrial capital in the equity markets, “market forces adapted ... by re-concentrating ownership into the hands of fiduciaries that were able to take up the task of a large owner.”<sup>44</sup>

Autonomous adaptation by market forces, as reflected, in part, through the institutionalization of the equity markets in the US and the trend towards the MOBM, pose a

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<sup>40</sup> The findings by Brancato and Rabimov serve to illustrate the extent of institutionalization in the US. They found, for example, that total institutional assets increased from \$2.7 trillion in 1980 to \$27.1 trillion in 2006. Total institutional holdings increased from \$8.7 billion in 1950 (or 6.1% of total equity markets) to \$12.9 trillion in 2006 (or 66.3% of total equity markets). Brancato and Rabimov, *2008 Report*.

<sup>41</sup> Pichhadze, "Market Oriented Blockholder Model."; ———, "Private Equity."

<sup>42</sup> ———, "Private Equity."

<sup>43</sup> Williamson, "Economics of Governance."

<sup>44</sup> Pichhadze, "Private Equity," 20.

further challenge to the proxy rules. Oversight of the MOBM (as a trend) resulted in the embedding of the distortion outlined above within the regulatory framework. In a way, the embedding of the distortion raises the issue of positive-feedback and the perpetuation of an error – or, the embedding of the error into the fabric of the regulatory framework of the securities markets – discussed in Part III(B)(2) of this chapter.

## 2. Creation of Systemic Risk

As noted earlier, in a well-functioning system, an internal error in the system should be detected and corrected – thereby introducing evolutionary improvements in the system. As such, the misconceived basis of the proxy rules (as being based on the presumption of atomistic ownership) should have been detected as an error in the system and corrected in light of the increasing change in the character of public share owners. Instead, what we see is the embedding and carrying forward of the error.

Were the error to remain within the confines of the proxy rules, it would be plausible to argue that it would only constitute a legal error that arose due to a misreading of the Berle and Means study. A legal error may be corrected by legislation upon its discovery.<sup>45</sup> The legal error, however, was not discovered and acted upon.

In addition, regulatory understanding vis-à-vis public corporate ownership extends beyond the proxy rules and touches upon a number of key governance arrangements.<sup>46</sup> This

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<sup>45</sup> Luhmann, *Law As a Social System*: 105-20.

<sup>46</sup> For example, it has been observed that ownership structure affects such matters as (i) takeovers and defensive measures adopted by firms to thwart such activity, (ii) conflict of interest rules and related party rules, (iii) significant corporate action and disclosure rules, and (iv) board independence. See, e.g., Bebchuk and Hamdani, "Elusive Quest."; Kraakman, *Anatomy of Corporate Law*.

means that any distortion vis-à-vis ownership in one part of the regulatory framework affects many other areas (i.e., there is a spill-over effect of the legal error). Consequently, the legal error is elevated to the level of systemic error that poses the hazard of giving rise to systemic risk.

### **3. Efficiency Implications of the Risk**

The failure to address the above error also presents issues of efficiency. According to Williamson,<sup>47</sup> in order to promote efficiency in the markets, the process of autonomous adaptation described above should be supplemented (or reciprocated) by a second type of adaptation – a consciously coordinated adaptation, which is accomplished in a conscious, deliberate and purposeful manner through the use of administration.<sup>48</sup> Pichhadze argued that consciously coordinated adaptation to be displayed by the SEC should supplement the trend towards the MOBM, which reflects autonomous adaptation by the market, in order to have efficiency in the markets.<sup>49</sup>

For the SEC, consciously coordinated adaptation means that the organization adapts the regulatory framework to reflect changes in the landscape subject to its oversight. Consciously coordinated adaptation also means that the SEC must review the regulatory framework for gaps that may give rise to imbalance.

The principal change of concern to the discussion here is the institutionalization of the US capital markets. An observation of this process, and its extent, should have prompted the SEC to re-evaluate the regulatory focus on the shareholder-manager tension and, instead, turn its

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<sup>47</sup> Williamson, "Economics of Governance."

<sup>48</sup> Administration in the context of the capital markets refers to securities regulators such as the Securities and Exchange Commission (SEC).

<sup>49</sup> Pichhadze, "Private Equity."

attention to the minority shareholder-blockholder type tension to better reflect market realities from an ownership perspective and the tensions that these realities give rise to.<sup>50</sup> The failure to do this resulted in the embedding an error and amplification of regulatory gaps within the system.

As the discussion showed, however, the SEC has not been successful in exhibiting consciously coordinated adaptation and, as such, in mitigating the imbalance in the framework. Consequently, it can be argued that the SEC became the source of systemic risk in the regulatory framework of the securities markets. Accordingly, we arrive at regulatory systemic risk.

#### **4. Path-Dependency Explanation?**

The failure to observe the regulatory gaps might also be explained by path dependencies within the SEC vis-à-vis institutional investors. Prior to the passing of the proxy rules in the US, institutional investors were viewed as agents for the diffusion of public corporate ownership and for the democratization of the public firm.<sup>51</sup> This is despite the fact that institutional investors' investments at the time were restricted primarily to debt securities.

After the financial crisis of 1929, institutional investors assumed greater importance from a public policy perspective in that they were used in mitigating social problems associated with such matters as unemployment and old age.<sup>52</sup> It would appear that the significance of institutional investors did not escape the SEC, as a 1951 comment in the *Yale Law Journal*

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<sup>50</sup> See, e.g., ———, "Market Oriented Blockholder Model."; ———, "Private Equity."; Leo E. Jr. Strine, "One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?," *Business Lawyer* 66, no. 1 (2010).

<sup>51</sup> Carver, "Diffusion of Ownership."; Cox, "Policy-Holder."

<sup>52</sup> Naess, "Changing Patterns."

noted: "the welfare of the institutional investor has attracted more attention [from the SEC] than the welfare of the investor to whom he sells."<sup>53</sup>

The policy significance attached to institutional investors along with the literature's view of institutional investors as agents for the diffusion of corporate ownership may explain why institutional investors are not viewed as blockholders. In addition, it may also explain why institutional investors are viewed as having homogeneous interests with other shareholders,<sup>54</sup> despite the fact that shareholders exhibit heterogeneous interests.<sup>55</sup> These views of institutional investors, however, can be said to have generated a path-dependency vis-à-vis this class of shareholders that, when combined with the regulatory distortion described above, works to amplify the distortion to yield undesirable outcomes.

This is evident in the SEC Proxy Access Rule. The rule is embracive of all shareholders in allowing them to participate in the process of nominating directors. The threshold requirements, however, are such that only a select group of shareholders can meet these requirements – a class consisting mainly of institutional investors. Given that shareholders exhibit heterogeneous interests and preferences, the strengthening via legislation of one group over another, along with recognition that this group also represents a blockholder group, magnifies the concerns expressed earlier. More particularly, the SEC Proxy Access Rule serves to amplify the tension between minority shareholders and blockholders.

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<sup>53</sup> Editorial, "Meaning of Control."

<sup>54</sup> Hansmann and Kraakman, "End of History," 48-49.

<sup>55</sup> Pichhadze, "Private Equity."

As such, the SEC Proxy Access Rule, in effect, reflects and perpetuates (1) the views of institutional investors by the SEC and, consequently, (2) the regulatory gaps within the regulatory framework vis-à-vis ownership.

## V. CONCLUSION

The Dodd-Frank Act addressed many deficiencies within the regulatory framework governing the financial markets. Yet, it failed to address others. As such, it also represents a missed opportunity for the closing of gaps within the regulatory framework governing the securities markets.

In particular, the Dodd-Frank Act introduced s. 971, Proxy Access, which authorized the SEC to introduce the SEC Proxy Access Rule. This section is inconsistent in terms of regulatory purpose with other parts of the Dodd-Frank Act. Section 971 also represents a regulatory failure in that the amendments to the proxy rules resulted in the amplification of risks contained within the regulatory framework governing the securities markets. As such, this section also diminishes from the Dodd-Frank Act's ability to meet its overarching purpose of the reduction of systemic risk.

We are only beginning to witness the negative implications and/or manifestation of regulatory systemic risk. Addressing the risk in the context of corporate ownership requires an examination of the regulatory framework of the areas that are impacted by the concept of ownership. A wider review of the regulatory framework may find other areas not addressed in this chapter that give rise to regulatory systemic risk and, as a result, to corrections. These



initiatives, which require administrative time and effort, are necessary if one is to ensure efficiency of the capital markets and investor confidence in the regulatory framework.

Conversely, a lax attitude towards regulatory systemic risk may result in similar outcomes as in the case of systemic risk. This was recently captured by one commentator in the following terms: “Systemic risk was previously considered by some people to be a form of ‘bogey man’ used to frighten financiers but which did not really exist. The financial crisis of 2008 proved that the risk of systemic collapse was real.”<sup>56</sup>

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<sup>56</sup> Hudson, *The Law of Finance*: 29.

## CHAPTER 6, THE SEC AS A LEARNING REGULATOR: LESSONS FROM PROXY ACCESS\*

Is the US Securities and Exchange Commission a “learning regulator,” capable of acquiring new knowledge and adapting the regulatory framework to the dynamic nature of the securities markets? This epistemological question is examined in the context of the Commission’s recent proxy access rule. Descriptively, I show that the introduction of the proxy access rule, suggests that the Commission is not a learning regulator. The normative implication that follows this observation is that the Commission, as the administrative body charged with overseeing the supervision of the regulatory framework governing the securities markets, is facilitating the introduction of regulatory systemic risk. The assessment in this article relies on historical, sociological, institutional, organizational, and political economy approaches.

### I. INTRODUCTION

In the aftermath of the 2008 economic crisis, the Securities and Exchange Commission’s (“SEC” or “Commission”) reputation was subject to criticism for failing to adequately address scandals

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\* This chapter is an updated and expanded version of an earlier version which originally appeared in Pichhadze, Aviv, 2011. “Ownership, Governance, and US Securities Regulation: ‘The Case for the Learning Regulator’,” Osgoode CLPE Research Paper No. 09/2011. Available on SSRN: <http://ssrn.com/abstract=1760054>. A modified version of this chapter will appear in Pichhadze, Aviv, 2012. ““The Securities and Exchange Commission and the Ownership Narrative,” *William & Mary Policy Review* (Forthcoming).

and failures that shook the markets' and investors' confidence in the regulator.<sup>1</sup> The SEC, under the leadership of Mary Schapiro, was determined to reassert the agency's reputation as a regulator and enforcer of securities legislation. This article examines the performance of the SEC through the lens of one of the initiatives adopted by the SEC in the post-2008 economic crisis era – proxy access, which was introduced as rule 14a-11 under the Securities Exchange Act of 1934 (“SEC Proxy Access Rule” or “Rule”) in August 2010.<sup>2</sup>

The adoption of the SEC Proxy Access Rule was authorized by s. 971 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act). The Rule was intended to facilitate the rights of shareholders to nominate directors on corporate boards as part of the SEC's response to the heightened public and regulatory interest in increased regulation of the financial markets and the extension of regulation into new areas that followed the 2008 financial crisis. Though the SEC Proxy Access Rule was recently vacated by the District of Columbia Circuit of the US Federal Court of Appeal<sup>3</sup> by noting “the Commission acted arbitrarily and capriciously for having failed once again ... adequately to assess the economic effects of the new rule,” to a student of the governance literature, the Rule raises a related question about the performance of the SEC. The inquiry in this article is whether the SEC is a learning regulator.

By a learning regulator, I mean an administrative agency that displays adaptability to the changing and evolving environment subject to its oversight. Adaptability, in this context, refers

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<sup>1</sup> Dan Margolies and Rachelle Younglai, "ANALYSIS-Schapiro gets US SEC out of crosshairs," *Reuters News*(2010), <http://www.reuters.com/article/2010/02/01/us-sec-schapiro-analysis-idUSTRE61025R20100201>.

<sup>2</sup> SEC, Facilitating Shareholder director Nomination 17 CFR Parts 200, 232, 240 and 249.

<sup>3</sup> *Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission* Case No. 10-1305, C.A.D.C., July 22, 2011 [Business Roundtable and Chamber of Commerce].

to the regulator's displayed awareness of trends in the regulated environment, where awareness is evidenced by appropriate amendments to legislation to reflect the recognition of such insights. The costs of a regulator failing to exhibit learning are the introduction of policies and rules that place a negative pressure on the regulated environment that may also have efficiency and normative consequences to actors in that environment.

The suitability of the proxy rules, in general, and the SEC Proxy Access Rule, in particular, for the evaluation of the SEC's performance as a learning organization rests in the fact that the regulation of the proxy process is one of the agency's original responsibilities delegated to it by the legislator.<sup>4</sup> As such, any deficiencies and/or achievements in the proxy rules reflect directly on the SEC's performance.

Evaluation of regulatory performance through the lens of the proxy rules, in this article, is carried out by looking at the nexus between public firm ownership and regulation, on the one hand, and the relationship between the regulator's stated objective and the consequences of regulatory intervention in the proxy arena, on the other. This approach allows for the determination of whether the SEC Proxy Access Rule serves as an example of what Cass Sunstein described as the "paradoxes of the regulatory state" or regulatory strategies that "achieve an end precisely opposite to the one intended."<sup>5</sup>

The possibility that an administrative agency can create rules that may be self-defeating does not necessarily render the agency as a non-learning organization. Yet, the fact that the agency fails to grasp the realities in the environment subject to its oversight over a prolonged

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<sup>4</sup> SEC Proxy Access Rule.

<sup>5</sup> Cass R. Sunstein, "Paradoxes of the Regulatory State," *The University of Chicago Law Review* 57, no. 2 (1990): 407.

period of time, and, consequent to which, it engages in the production of self-defeating rules, does render it a non-learning regulator – at least for the purposes of that particular situation. That is, learning is examined by looking at how the SEC translated its organizational knowledge vis-à-vis ownership in the context of the SEC Proxy Access Rule into action.

Three observations lend themselves to the conclusion that the SEC is not a learning organization. First, the adoption of the Rule as part of the Dodd-Frank Act may point to a shift in regulatory philosophy by the SEC from the liberal progressive approach towards a corporatist one despite the fact that the justifications provided by the SEC for the Rule are inconsistent with either the Rule's purpose or the Commission's investor protection vision. Second, the Rule, as representing a short-term strategy aimed at shielding the Commission's legitimacy from criticism about its handling events that led up to, and following, the 2008 economic crisis, is inconsistent with risk regulation strategies. Finally, the Rule may represent the agency's avoidance of one of the main issues inflicting corporate governance in the US – the minimal regulatory address to the changing nature of ownership in the public markets. These issues are addressed in the remainder of this article following a brief description of the Rule and one of the grounds the Court of Appeal relied upon in vacating the Rule.

## **II. THE SEC PROXY ACCESS RULE**

The impetus for the current version of the SEC Proxy Access Rule,<sup>6</sup> according to the SEC, was the erosion in investor confidence, as a consequence of shareholder concerns about

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<sup>6</sup> For a brief discussion on the recent history of proxy access see, e.g., Grundfest, "SEC's Proposed Proxy Access Rules."; Larcker and Tayan, "Proxy Access: A Sheep, or Wolf in Sheep's Clothing?".

accountability and responsiveness of companies and boards to shareholder interests, which followed the 2008 economic crisis.<sup>7</sup> To correct this, the SEC reasoned that the principal way for shareholders to hold boards accountable and influence matters of corporate policy would be through the nomination and election of directors.<sup>8</sup> To facilitate this, the agency introduced the SEC Proxy Access Rule, which required a company's proxy materials to provide shareholders with information about, and the ability to vote for, a shareholder's, or a group of shareholders', nominees for director.

The Rule was premised on the perception that the typical firm in the US is characterized by fragmented ownership structure, where fragmented owners need government intervention to protect them from managers who may act adversely to the promotion of the shareholders' welfare. This view is often associated with Adolf Berle and Gardiner Means<sup>9</sup> that empirically showed the separation of ownership from control in America's largest corporations by the early 1930s.

The shareholder primacy argument, which appears to be guiding the SEC Proxy Access Rule, is that holding corporations and their boards accountable to shareholders' long-term value maximization<sup>10</sup> (and, hence, social welfare) would be achieved by allowing shareholders to nominate board members on the corporate proxy.

To take advantage of the SEC Proxy Access Rule, a shareholder or group of shareholders would have had to continuously hold at least 3% of the voting stock entitled to be voted for a

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<sup>7</sup> SEC Proxy Access Rule, 7.

<sup>8</sup> *Ibid*, 8.

<sup>9</sup> Berle and Means, *Modern Corporation*.

<sup>10</sup> For views representing shareholder primacy arguments see, e.g., Hansmann and Kraakman, "End of History."

period of at least three years prior to the date the nominating shareholder or group submits notice of its intention to take advantage of the rule, and must have continued to own those shares through the date of the annual meeting.

According to some commentators, the rule was problematic given that it mainly empowered a particular group of shareholders, namely institutional investors, at the expense of other investors.<sup>11</sup> Aviv Pichhadze, for example, argued the rule distorted the process in favor of institutional investors rather than promote corporate democracy as was intended.<sup>12</sup> The Court of Appeal in *Business Roundtable and Chamber of Commerce* expressed similar concerns (at p. 14) by observing that “[n]otwithstanding the ownership and holding requirements, there is good reason to believe institutional investors with special interests will be able to use the rule and ... ‘public and union pension funds’ are the institutional investors ‘most likely to make use of proxy access.’” The Court of Appeal went on to consider (at p. 14) the implications of the use of the rule by institutional investors:

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<sup>11</sup> Alexander M. Cutler, "Detailed Comments of Business Roundtable on the Proposed Election Contest Rules and the Proposed Amendment to the Shareholder Proposal Rules of the U.S. Securities and Exchange Commission," Business Roundtable, [http://businessroundtable.org/uploads/hearings-letters/downloads/BRT\\_Comment\\_Letter\\_to\\_SEC\\_on\\_File\\_No\\_S7-10-09.pdf](http://businessroundtable.org/uploads/hearings-letters/downloads/BRT_Comment_Letter_to_SEC_on_File_No_S7-10-09.pdf); Grundfest, "SEC's Proposed Proxy Access Rules."; ———, "Measurement Issues in the Proxy Access Debate", *Center for Corporate Governance at Stanford University Working Paper No. 71; Stanford Law and Economics Olin Working Paper No. 392*(2010), <http://ssrn.com/abstract=1538630>; Aviv Pichhadze, "Regulatory Systemic Risk in US Securities Regulation," *Law and Financial Markets Review* 5, no. 3 (2011); J. W. Verret, "Defending against Shareholder Proxy Access: Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank," *Journal of Corporation Law* 36, no. 2 (2011).

<sup>12</sup> Pichhadze, "Regulatory Systemic Risk."

... the Commission failed to respond to comments arguing that investors with a special interest, such as unions and state and local governments whose interests in jobs may well be greater than their interest in share value, can be expected to pursue self interested objectives rather than the goal of maximizing shareholder value, and will likely cause companies to incur costs is unlikely to be elected. ... By ducking serious evaluation of the costs that could be imposed upon companies from use of the rule by shareholders representing special interests, particularly union and government pension funds, we think the Commission acted arbitrarily.

We can frame the concerns expressed by the Court of Appeal in *Business Roundtable and Chamber of Commerce* and by critics of the SEC Proxy Access Rule using Sunstein's<sup>13</sup> terminology of regulatory paradoxes. Framed this way, these concerns appear to lend themselves to the argument that the SEC Proxy Access Rule can be characterized as a self-defeating regulatory strategy given that, rather than achieve the intended goal of investor protection, the rule had the potential for benefiting but a particular class of investors – institutional investors.<sup>14</sup>

### **III. SHAREHOLDER PROTECTION AND PUBLIC INTEREST**

On reviewing the text of the final rule, the fact that the principal beneficiaries of the SEC Proxy Access Rule would be institutional investors was, it appears, clear to the SEC. Yet, the Commission seems not to have been overly troubled with the outcome of this rule that was in

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<sup>13</sup> Sunstein, "Paradoxes."

<sup>14</sup> For a study showing that the SEC Proxy Access Rule may have negative implications to shareholder wealth and implicating the negative effect of institutional holdings of such wealth see Grundfest, "Measurement Issues in the Proxy Access Debate".



fact concerned with the rights of individual shareholders and not of the shareholder class or body. As the SEC pointed out in the rule:

Second, the argument that there is an inconsistency between mandating inclusion of shareholder nominees in company proxy materials and our concern for the rights of shareholders under the federal securities laws mistakenly assumes that basic protection of, and rights of, particular shareholders provided under the federal proxy rules should be able to be abrogated by “the shareholders” of a particular corporation, acting in the aggregate. The rules we adopt today provide individual shareholders the ability to have a director nominees included in the corporate proxy materials if state law and governing corporate documents permit a shareholder to nominate directors at the shareholder meeting in the requirements of Rule 14a-11 are satisfied. ... *When the federal securities laws establish protections or create rights for security holders, they do so individually not in some aggregate capacity.*<sup>15</sup>

[Emphasis added]

The emphasis on the “individual” in the SEC Proxy Access Rule is interesting from a political economy and regulatory thinking perspectives.

#### **A. THE SEC’S APPROACH TO “INVESTOR PROTECTION”**

The Rule, as favoring one group of shareholders over another due to the former’s ability to meet the threshold requirements contemplated by the Rule, appears to be inconsistent with the SEC’s assertion that the rule had been deemed “necessary and appropriate in the public interest and for the protection of investors.” When referring to the obligation of “protection of investors,” one would assume that the term “investors” refers to the totality of investors. As such, a rule adversely affecting non-institutional shareholders may be deemed inadequate.

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<sup>15</sup> SEC Proxy Access Rule, 18.

The marriage of “public interest” and “investor protection” and the seemingly favorable treatment of one group of investors over another may not, however, be inconsistent with the SEC’s approach to these two ideas. As Anne Khademian observed, the SEC is not clear about the type of investor on whose behalf its investor protection mandate should be advocated: the retail investors, the investor who invests through funds, or the institutional investor. Such uncertainty is usually resolved by the agency through the application of the concept of public interest.<sup>16</sup>

“[T]here is nothing intrinsically obvious about the public interest in regulatory matters,”<sup>17</sup> however, Khademian pointed out. The reason is found in the fact that “[a]gencies must deal with many different interests, each of whom claims to represent the public. In reality they simply represent another interest broadly or narrowly defined.”<sup>18</sup> Consequently, ruling in the public interest, in the case of the SEC, means ruling in favor of one interest group over another.<sup>19</sup>

This balancing act between different, and possibly conflicting, interests employed by the regulator utilizes a calculus that is designed to reduce the possibility of the agency’s rules being successfully challenged in the courts and having its status as an enforcer undermined.<sup>20</sup> But, as Harvey Pitt, former Chair of the SEC, recently pointed out, “[i]n carrying out its mission, the

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<sup>16</sup> Khademian, *The SEC*: 84-85.

<sup>17</sup> *Ibid.*, 85.

<sup>18</sup> *Ibid.*, 85-86.

<sup>19</sup> For arguments about the role of interest group politics in the contest of the SEC Proxy Access Rule see, e.g., Grundfest, "SEC's Proposed Proxy Access Rules."; Pichhadze, "Regulatory Systemic Risk." For a discussion of the role of interest group politics in the context of the wider reform measures adopted consequent to the 2008 economic crisis see, e.g., Daniel Carpenter, "Institutional Strangulation: Bureaucratic Politics and Financial Reform in the Obama Administration," *Perspectives on Politics* 8, no. 3 (2010).

<sup>20</sup> Khademian, *The SEC*: 86.

SEC should shuck its erroneous view that it is an enforcement agency with regulatory powers and start acting like a regulatory agency that also has enforcement powers.”<sup>21</sup> Switching the hats from enforcer to regulator would allow the SEC to achieve two objectives. First, it would allow the agency to avoid some unintended consequences in its rule-making role, such as the empowerment of financial blockholders in the case of the SEC Proxy Access Rule. Second, it would reduce the possibility of successful challenges of the agency’s rules in the courts, as in the case of the Rule, that may undermine its legitimacy.

### **B. THE SEC’S “U-TURN” ON ITS LIBERAL PROGRESSIVE ROOTS**

The suggestion that the SEC is part of the political economy process would not be remarkable if it were not tied to a suggestion that the agency is changing its philosophical approach to regulation. More particularly, it is arguable that the empowerment of institutional investors via the SEC Proxy Access Rule is the result of the agency moving away from its liberal progressive roots toward a corporatist one, given that institutional investors are seen in some quarters of the corporate governance literature as promoting the benefit of all shareholders and, possibly, society at large.<sup>22</sup> Yet, such conclusions are hazardous for they indicate a state of confusion vis-à-vis basic concepts and definitions.

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<sup>21</sup> Harvey L. Pitt, "Bringing Financial Services Regulation into the Twenty-First Century," *Yale Journal on Regulation* 25, no. 2 (2008): 323.

<sup>22</sup> See, e.g., Hansmann and Kraakman, "End of History."

## 1. Liberal Pluralism versus Corporatism

In an analysis of the Dodd-Frank Act, David Skeel<sup>23</sup> argued that the Act represented a corporatist approach to regulation in opposition to the liberal pluralism approach taken to financial regulation in the 1930s as part of the New Deal measures adopted by the government of Franklin D. Roosevelt (FDR) in the aftermath of the Great Depression of 1929. The implications of Skeel's observations to securities regulation mean a turn away from the progressive roots of American securities legislations.<sup>24</sup> It also means the SEC and the supporters of the Rule might have miscomprehended implications of the Rule to shareholder.

The differences between the liberal pluralism and corporatist approaches to regulation are illustrated in the following passage by Bratton and Wachter:

Under pluralism, only the preferences of individuals in their role as citizens count in the welfare calculus of government policy, and competition for the votes of individuals in a political marketplace determines policy outcomes. Corporatism privileges cooperation over competition and emphasizes group over individual interests. It assumes that government, through consultation with the major groups in society, can articulate and objectively cognizable "public interest." Once the public interest is expressed, government calls on the various groups, with the corporation being one of the most important, to adapt their position in support of it.<sup>25</sup>

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<sup>23</sup> David A. Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences* (Hoboken, N.J.: Wiley; Chichester: John Wiley, 2011).

<sup>24</sup> Moley, *After Seven Years*; Tugwell, "Progressive Orthodoxy."

<sup>25</sup> Bratton and Wachter, "Shareholder Primacy's Corporatist Origins," 102-03.

Thus, if Skeel's assertions are correct, the emphasis of SEC Proxy Access Rule adopted pursuant to the Dodd-Frank Act should be on the benefits gained by society at large from the financial system. It is quite obvious that the SEC's narrow interpretation of "investor" as meaning individual investor, as opposed to shareholders in general, may in fact promote the agenda of individual investors rather than the social benefit of all of the corporation's constituencies. Unless, of course, the SEC was, wrongly, of the opinion that institutional investors, who focus on short-term financial results, would not be in conflict of interest with the legal duties owed to their beneficiaries in representing the interests of society at large.<sup>26</sup>

## 2. Political Economy at Play

There are also political economy implications to the seemingly new regulatory approach taken by the SEC. Both liberal pluralism and corporatism acknowledge the presence of a political economy process. The difference between the two approaches, according to Bratton and Wachter, rests in whose preferences are taken into account by the policymaker.<sup>27</sup>

Under liberal pluralism, individuals with shared interests form advocacy groups to try and gain favorable outcomes but "[a]lthough corporations, unions, and interest groups count and express their official views, they count only to the extent that they offer informed judgments, political donations, or control votes."<sup>28</sup> In comparison, under corporatism groups operate as political actors and "it is the groups' votes that determine government policy, with the more

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<sup>26</sup> Henry Manne, for example, noted that attaching institutional investors with the guardianship position for the sake of all shareholders of a public firm might result in causing institutional investors to breach their primary duty. A duty owed to their named beneficiaries; in Manne, "Higher Criticism."

<sup>27</sup> Bratton and Wachter, "Shareholder Primacy's Corporatist Origins," 113.

<sup>28</sup> Ibid.

powerful groups having the most votes.”<sup>29</sup> The emphasis under the corporatist model is on cooperative relations among groups and between the state and different groups. The government, in consultation with major groups, eventually articulates the “public interest.” Once the “public interest” is expressed, the various groups are expected to adapt their policy to support it.<sup>30</sup>

We can see the potential for a corporatist element in the context of our discussion. The SEC, under the leadership of Schapiro determined that addressing proxy access was a priority for the agency.<sup>31</sup> This proposal had support from labor unions and pension funds,<sup>32</sup> who have been trying to gain access to influence corporate decision-making,<sup>33</sup> for the introduction of the Rule. As a comment in the Wall Street Journal noted, “Dodd-Frank empowered the SEC to make good on this union dream.”<sup>34</sup> These powerful supporters of the Rule are also supporters of the Democratic Party that both controlled the SEC and introduced the rule into legislation as part of the Dodd-Frank Act.<sup>35</sup>

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<sup>29</sup> Ibid.

<sup>30</sup> Ibid.

<sup>31</sup> Schapiro, has expressed her commitment to the introduction of the SEC Proxy Access Rule in the following terms: “Speaking for myself ... I intend to make proxy access – meaningful opportunities for a company’s owners to nominate its directors – a critical part of the Commission’s agenda in the coming months,” in Schapiro, “Testimony Concerning Enhancing Investor Protection 2009”.

<sup>32</sup> Senate Committee on Banking Housing and Urban Affairs, “Report of the Senate Committee on Banking, Housing, and Urban Affairs regarding The Restoring American Financial Stability Act of 2010,” 147.

<sup>33</sup> Sargent and Honabach, “Proxy Regulation and the Corporation Governance Debate, § 1:1 Introduction.”

<sup>34</sup> Wall Street Journal, “SEC Smackdown,” *Wall Street Journal* 2011.

<sup>35</sup> Pichhadze, “Regulatory Systemic Risk,” 177.

### 3. Shareholder Primacy and Corporatism – Inconsistent Perspectives

One supporter of the corporatist approach to regulation was Adolf Berle, one of the co-authors of *The Modern Corporation and Private Property*,<sup>36</sup> which is often quoted in support of the shareholder-oriented amendments.<sup>37</sup> Bratton and Wachter, however, observed that the connection between Berle and the shareholder primacy approach de-contextualizes Berle's observations vis-à-vis the dispersion of ownership in large firms from his corporatist ideology, which is at odds with shareholder-primacy claims. To the extent that Berle influenced the securities legislations adopted as part of the New Deal in the 1930s, it was not through the infusion of the corporatist approach.

The Securities Act of 1933 and the Securities Exchange Act of 1934 reflected the liberal pluralism approach to regulation advocated by Brandeis and his followers. As Raymond Moley commented in 1939, "the idea of having a securities act, in the first place, was an expression of the Wilson-Brandeis regulatory philosophy."<sup>38</sup> Consequently, the suggestion by commentators such as Skeel that the Dodd-Frank Act (which authorized the adoption of the SEC Proxy Access Rule) embraced a corporatist approach to regulation, also suggests that the SEC was turning away from its liberal progressive roots.

The switch from liberal progressivism to corporatism on the part of the SEC, however, does not necessarily translate into the achievement of the Rule's stated goal of corporate accountability nor does it mean that the Rule represents the meeting of corporatist ends. The empowerment of institutional investors (who show commitment and ability to participate in

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<sup>36</sup> Berle and Means, *Modern Corporation*.

<sup>37</sup> Bratton and Wachter, "Shareholder Primacy's Corporatist Origins."

<sup>38</sup> Moley, *After Seven Years*.

corporate life) by the SEC Proxy Access Rule appears to be contradictory to corporatism because the empowerment of institutional investors does not translate smoothly into the furtherance of social welfare. In addition, the rule would have merely replaced one entity charged with making welfare decisions without public accountability – the manager – with another – the institutional investor.<sup>39</sup> According to Bratton and Wachter, such a result would have been unacceptable to Berle, who expressed concern over the institutionalization of the US markets.<sup>40</sup>

#### **IV. THE SEC'S LEARNING ABILITY: AN OWNERSHIP PERSPECTIVE**

Recall Khademian's observation that the SEC is vague about the identity of the investor in whose favor its investor protection mandate should be exercised. The reason offered by Khademian for this lack of knowledge, is the failure of the SEC's enabling statutes to provide appropriate guidance.<sup>41</sup> Consequently, the agency is left to exercise discretion in the public interest and through engagement in the political economy process. The connection between statutory vagueness and an administrative agency's vulnerability to the private interests they were created to regulate, is well known in the literature on administrative agencies and political economy.

According to James Freedman such statutory vagueness or lack of guidance "in the delegation of power may be appropriate [and even desirable] when an agency is first created to deal with a problem not yet fully understood. But when such vagueness is permitted to persist over decades, it becomes, first, a signal of Congress' refusal to provide the agency with a sense

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<sup>39</sup> Bratton and Wachter, "Shareholder Primacy's Corporatist Origins," 148-49.

<sup>40</sup> Rosen, "New Realities."

<sup>41</sup> Khademian, *The SEC*.



of mandate, and, then, a temptation to private groups to exert pressure and influence.”<sup>42</sup> This, in turn, places a question mark as to the legitimacy of the administrative process and challenges both its integrity and independence.

The intention here, however, is not to challenge the legitimacy of the SEC. Rather, the article seeks to show that irrespective of whether the SEC’s philosophical approach to regulation is defined as corporatist or liberal progressive, the anomalous result achieved under the SEC Proxy Access Rule of empowering institutional investors, is the result of the SEC’s failure to engage in a learning process vis-à-vis the ownership distortion contained in the 1934 Act. I first describe the ownership distortion and provide some possible explanation for it. Next, I develop the learning regulator framework, apply the framework to the SEC Proxy Access Rule, and discuss the consequences of the Rule.

#### **A. INVESTOR PROTECTION IN THE NEW DEAL: A DISTORTED VIEW**

Both the 1933 and 1934 Acts, as already noted, were part of the measures adopted by FDR’s government as part of the New Deal. The New Deal “had been sold to the public in 1932 and 1934 as a means of achieving security and stability.”<sup>43</sup> FDR “believed that government not only could, but should, achieve the subordination of private interests to collective interests, substitute co-operation for the mad scramble of selfish individualism.”<sup>44</sup> This philosophy, according to Moley, was “the bywords of a progressivism that for over sixty years had preached the need for

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<sup>42</sup> James O. Freedman, “Crisis and Legitimacy in the Administrative Process,” *Stanford Law Review* 27, no. 4 (1975): 1056.

<sup>43</sup> Moley, *After Seven Years*: 310.

<sup>44</sup> *Ibid.*, 14.

controlling the increasing concentration of economic power and the need for converting that power to social ends.”<sup>45</sup>

While the concentration of economic power in large corporations was of concern, this anxiety was also accompanied by the observation that in these large corporations, ownership was fragmented and control of the enterprise was subject to unaccountable managers. The empirical proof for this was provided by Berle and Means,<sup>46</sup> who described the divorce of ownership from control in large public corporations and the extent of ownership fragmentation in those firms.<sup>47</sup> To see how this concern manifested itself in the 1934 Act, we can look at the proxy rules found in s. 14(a).

One pre-1929 corporate practice that the 1934 Act sought to remedy was the disenfranchisement of shareholders by corporate managers via the proxy system. In order to avoid the abuse of shareholders by managers who often asked for proxies without providing shareholders with information, s. 14(a) of the 1934 Act introduced the federal proxy rules which apply to publicly listed firms. “Section 14(a) of the Exchange Act gave the [SEC] almost plenary authority to regulate the proxy process.”<sup>48</sup>

The regulatory vision of the proxy rules found in s. 14(a) of the 1934 Act was the result of a combination of three forces. These three forces were distrust of management, distrust of corporate actors and financial markets, and concern for the protection of individual investors.<sup>49</sup>

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<sup>45</sup> Ibid.

<sup>46</sup> Berle and Means, *Modern Corporation*.

<sup>47</sup> Hessen, "The Modern Corporation."

<sup>48</sup> Brown, "The Regulation of Corporate Disclosure. § 2.01 Historical Overview."

<sup>49</sup> Pound, "Proxy Voting," 249.

According to John Pound, “the reform vision was essentially populist, aimed at empowering the small investor and thereby constraining those perceived to have excess power and privilege. I term the vision investor protection.”<sup>50</sup> The emphasis here is on “the small investor.” The significance of this is based on the fact that the legislation, as originally designed, incorporated not only Berle and Means’ observations about the fragmented nature of ownership in large firms but also some of their biases.

The concerns expressed by Berle and Means related to America’s largest firms, which accounted for approximately 23% of the listed firms in their study. In these firms, ownership was sufficiently diffused to render monitoring of management by shareholders impracticable. Regulatory intervention was deemed necessary to minimize opportunistic behavior by management at the expense of shareholders. That is, the regulatory framework governing the proxy process sought to address the shareholder-manager tension.<sup>51</sup>

The remaining 77% of the listed firms in the Berle and Means study consisted of small- and medium-sized firms that were deemed by the authors as unimportant because these companies did not command any significant portion of the total assets in the market.<sup>52</sup> A complete separation of ownership from control was not observed in these firms and their ownership structure could be described as a blockholder mode of ownership displaying one or a few blockholders (whether controlling or not) along with fragmented owners.<sup>53</sup> In this class of

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<sup>50</sup> Ibid.

<sup>51</sup> Sargent and Honabach, "Proxy Regulation and the Corporation Governance Debate, § 1:1 Introduction."

<sup>52</sup> Berle and Means, *Modern Corporation*: 28.

<sup>53</sup> Cheffins and Bank made a similar observation in noting that “[t]hough Berle and Means are commonly credited with providing empirically that ownership was divorced from control in large U.S. companies, in fact fewer than

firms, the shareholder-manager tension did not feature prominently because of the presence of a blockholder capable of performing the monitoring function over management's activities. There was, however, a different type of concern in these firms – the potential abuse of minority (fragmented) shareholders by the blockholder. This is the minority shareholder-blockholder tension, which was not addressed by securities legislation.

By failing to address this category of tensions via legislation, an imbalance was created in the regulatory framework governing the securities markets in the US.<sup>54</sup> There may be two possible explanations for the failure of securities legislation to address the minority shareholder-blockholder tension. One explanation can be found in the distinction between “risks” and “dangers” in framing policy objectives. The other explanation might have its roots in investment theory that prevailed at the time.

### **1. Investment Theory Explanation**

To gain a glimpse into investment theory during the early decades of the 20th century, we can look, for example, at the writings of the Harvard economist Thomas Carver. Carver suggested that small investors (a class covering employees and/or those with modest incomes) should generally restrict their investments to shares of firms that are considered “dependable.”<sup>55</sup> Here, “dependable” firms appear to consist of firms that are well advanced in their corporate life cycle. As for all other public shares (likely referring to small- and medium-sized firms), Carver argued that these investments are the lot of the expert investor, and, we can suppose, the speculator.

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half off the two hundred companies they examined were under what they categorized as managerial control,” in Cheffins and Bank, “Is Berle a Myth,” 467.

<sup>54</sup> Pichhadze, “Regulatory Systemic Risk.”

<sup>55</sup> Carver, “Diffusion of Ownership,” 45.

Once these smaller firms attain stability, Carver explained, “the original investors may be tempted to sell to small investors who are seeking safety and who are willing to pay a high price to get it; that is, who are willing to invest for very small returns.”<sup>56</sup> The result is that “[u]nder this general policy the old well established industries would be owned more and more by large numbers of small investors ... who are not in a position to take many chances with their investments.”<sup>57</sup> Thus, according to Carver’s advice, the larger a firm grows and matures, and as its cash flow become more dependable, the firm’s blockholders may elect to sell their holdings (in whole or in part) and, as a result, the firm’s ownership will become increasingly diffused – creating an inverse relationship between ownership concentration and firm size.

Once we view Berle and Means and the fragmented ownership assumption underlying the regulatory measures adopted as part of the New Deal against the investment framework advanced by Carver, we see that the 1934 Act catered to a certain type of investor (i.e., the fragmented investor with modest means) in a certain type of company (i.e., the fragmented large public corporation). As such, “public interest” can be seen to denote the interest of the working class that sought to participate in the distribution of income surplus by large public firms. Incidentally, these investors also formed FDR’s voter pool and the justification of his reform agenda.

This, however, gave rise to an imbalance within the regulatory framework governing the capital markets. The imbalance stems from the gap (or fault-line) in the framework between the

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<sup>56</sup> Ibid., 46.

<sup>57</sup> Ibid.

views of ownership by the policymakers (and by extension the newly minted SEC) and the realities displayed in the marketplace.<sup>58</sup>

## 2. Considerations of “Dangers” and “Risks” in Policymaking

We can also explain the above distortion using a risk/danger dichotomy in policy-making. According to the German sociologist Niklas Luhmann,<sup>59</sup> the concept of “risk” should be differentiated from that of “danger.” Danger, he noted, refers to a case where future losses are not seen as a consequence of a decision but, instead, are attributed to an external factor. Risk, on the other hand, is seen as a consequence of a decision. We can frame this using the terminology of agents and principals. The principal faces a risk, if the hazard stems from the agent’s decision, that is, the hazard is internal to the principal-agent relationship. If, however, the hazard to the principal results from a decision of someone external to the principal-agent relationship, then, the hazard is classified as mere danger.

If we apply the danger/risk dichotomy in the context of our discussion, we see that shareholders can be divided into two groups: (i) those that were exposed to dangers and (ii) those that were exposed to risk. The difference between the two groups is one of degree between (a) the nature of hazard, (b) the identity of the decision-maker (agent), and (c) the identity of the party exposed to the hazard (principal).

Recall that the impetus for the securities legislation in the 1930s was the protection of fragmented investors from abuses by unaccountable corporate managers. Phrased differently,

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<sup>58</sup> Pichhadze, “Regulatory Systemic Risk.”

<sup>59</sup> Niklas Luhmann, *Risk: A Sociological Theory*, Communication and social order (New York: Aldine de Gruyter, 1993).

securities legislation seeks to address the exposure of shareholders to decisions by managers. Based on this, we can attempt to explain the reason for the imbalance in the legislation in favor of investors in large firms over individuals who invested in small- and medium-sized firms.

In the case of large firms with fragmented owners, shareholders (the principal) are unable to effectively monitor corporate managers (the agent) and, as such, shareholders are exposed to the hazard that managers' interests may not be identical to those of the shareholders in running the company. Thus, the fundamental concern to be addressed by regulation is the opportunistic behavior of managers at the expense of shareholders or the shareholder-manager tension. The hazard in these companies is the risk to shareholders that follows the decision of managers – a risk that was expected to be resolved by the enactment of the 1933 and 1934 Acts.

In small- and medium-sized firms, on the other hand, blockholders have the means and the incentive to monitor the performance of corporate managers. As such, the hazard that corporate managers will make decisions that are adverse to shareholders' interests is reduced. But blockholders may have interests that may diverge from other (minority) shareholders. The fundamental concern in this class of firms is the hazard that decisions by blockholders (agent) may adversely affect minority shareholders (principal) or the minority shareholder-blockholder tension. From the policymaker's perspective, however, this hazard was classified, in all likelihood, as mere "danger" that did not fall squarely within its intentions of protecting shareholders from management abuses. This is because the risk/decision dichotomy did not involve management (at least directly).

The classification of the minority shareholder-blockholder tension as danger and the consequential failure to address it via legislation, however, resulted in gaps or fault-lines in the

regulatory frameworks by failing to address the concerns of a shareholder class of a substantial portion of the listed firms in the 1930s.

## **B. THE OWNERSHIP DISTORTION STATUS QUO**

The risk/danger analysis and the ownership distortion just described were presented in historical context and contextualized to the period in which the imbalance was introduced into the regulatory framework. But they are equally relevant to the present. Over the course of the 20th century to the present, the American markets experienced the concentration of both economic power and ownership into the hands of institutional investors. For example, Carolyn Brancato and Stephan Rabimov<sup>60</sup> showed that total institutional holdings have increased from \$8.7 billion in 1950 (representing 6.1% of total equity markets) to \$12.9 trillion in 2006 (representing 66.3% of total equity markets). Their study also showed that institutional investors have increased their holdings in America's 1000 largest firms from 46.6% in 1987 to 76.4% in 2007.

Legal models, however, did not adjust adequately to this change. As Leo Strine recently pointed out, "[t]he existing model of corporate law focuses solely on the duties the managers owe to stockholders. It does not address the reality that most 'stockholders' are now themselves a form of agency, being institutional investors who represent end-user investors."<sup>61</sup> That is, current regulatory framework (and thinking) continues to emphasize the shareholder-manager tension but not the more appropriate minority shareholder-blockholder tension, where the blockholder is the institutional investor.

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<sup>60</sup> Brancato and Rabimov, *2008 Report*.

<sup>61</sup> Strine, "One Fundamental," 10.



These observations raise several related questions. First, is the SEC a learning regulator, as defined at the outset of this article? Second, provided that we deem the agency not to be a learning regulator, what are some of the assumptions/explanations for the SEC's inability to learn? Finally, what should the agency have done in order to display learning? These questions are explored below. One should note, however, that the determination of whether the SEC is a learning organization today should be based on its actions in the present and in the context of the SEC Proxy Access Rule. As Dvora Yanow pointed out, in the assessment of whether an organization displays learning, we should focus "on what we can see when we look at what people do, rather than searching for what might be going on only in their heads,"<sup>62</sup> and such an assessment is situation specific.

### **1. The Elements of a Learning Regulator**

Recall that a learning regulator is an administrative agency that displays adaptability to the changing and evolving environment subject to its oversight. Here, adaptability refers to the regulator's displayed awareness of trends in the regulated environment, where awareness is evidenced by appropriate amendments to legislation in a manner that reflects the regulator's recognition of such insights. Accordingly, becoming a learning regulator involves both observation and action based on such observation.

"Observation," in this context, means that the regulator has in place systems or procedures that allow it to take several acts in tandem. First, the regulator must be able to examine, and re-examine, the assumptions underlying the regulatory framework subject to its oversight. Second, it is essential that the regulator is able to monitor activity in the regulated

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<sup>62</sup> Dvora Yanow, "Seeing Organizational Learning: A 'Cultural' View," *Organization* 7, no. 2 (2000): 253.

environment. Third, it is necessary for the regulator to evaluate this activity in a manner that allows the regulator to benchmark the observed activity against the agency's existing organizational knowledge. Fourth, in the event that new knowledge gained deviated from existing organizational knowledge, the regulator must have systems that allow it to discard existing organizational knowledge in favor of the newly gained knowledge and assess the implications of such newly acquired knowledge to the regulatory framework subject to its oversight. "Action," in this context, refers to the regulator acting on newly gained knowledge via the introduction of appropriate amendments to the regulatory framework.

The learning regulator framework, therefore, offers administrative agencies that possess both rule-making and enforcement powers a structure that allows regulators to meet the challenges presented by the evolving regulated environment, including (i) the detection of errors embedded in the regulatory framework and changes in the behavior by regulated entities, (ii) the development of responses to regulatory errors and behaviors, (iii) the development of instruments and enforcement mechanisms that target the errors and behavior patterns, (iv) the development of mechanisms that facilitate assessment of regulatory performance in addressing challenges, and, finally, (v) the fostering of mechanisms that facilitate organizational changes to implement the lessons learned. Thus, the learning regulator framework is designed to reduce distortions within the regulatory framework and to ascertain that once risks to the regulatory framework present themselves, they will be exogenous rather than endogenous to the system;

that is, the framework is designed to reduce the possibility of risks to the system that originate with the regulator (i.e., endogenous risks).<sup>63</sup>

The concept of a learning regulator has institutional, management, and risk regulation dimensions. From an institutional perspective, a learning regulator engages in what Oliver Williamson referred to as consciously coordinated adaptation or adaptation that is achieved in a “conscious, deliberate, purposeful’ way with the use of administration.”<sup>64</sup> The concept of consciously coordinated adaptation is based on Chester Bernard’s organizational theory, which focused on the question of coordinated adaptation of market actors and the role of authority in achieving consent and cooperation of market actors in implementing decisions by administration.<sup>65</sup> This type of adaptation by a regulator is necessary in order to complement the adaptive capacity of market actors, which display what Williamson called autonomous adaptation or the spontaneous adaptation of market actors to changes in the market. When both adaptive capacities (i.e., those by markets and administration) are evidenced, according to Williamson, market efficiency is achieved. In the context of the capital markets, administration refers to the securities regulator.

From a management perspective, a learning regulator is able to narrow the gap between the agency’s mission (“where we want to be”) and reality (“where we are”) or what Peter Senge

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<sup>63</sup> As Bridget Hutter and Michael Power pointed out, “[o]rganizations are both centres for processing and handling risks and potential producers and exporters of risk.” Hutter and Power, “Organizational Encounters with Risk: An Introduction,” 1.

<sup>64</sup> Williamson, “Economics of Governance,” 4.

<sup>65</sup> ———, “Chester Barnard and the Incipient Science of Organization,” in *Organization Theory: From Chester Barnard to the Present and Beyond*, ed. Oliver E. Williamson (New York; Oxford: Oxford University Press, 1995); ———, “Economics of Governance.”

referred to as "creative tension."<sup>66</sup> "The principle of creative tension teaches that an accurate picture of current reality is just as important as a compelling picture of a desired future."<sup>67</sup> Senge argued that this tension can be resolved in one of two ways. On the one hand, the organization's leaders can take measures that attempt to raise reality toward the vision. Alternatively, the organization's leaders can lower the vision toward reality. To move reality toward vision, according to Senge, requires that the organization's leadership (i) understands, or has a clear picture of, what the organization's vision is, on the one hand, and (ii) has an accurate picture of reality, on the other.

Dealing with the creative tension has implications to approaches to decision-making:

Leading through creative tension is different than solving problems. In problem solving, the energy for change comes from attempting to get away from an aspect of current reality that is undesirable. With creative tension, the energy for change comes from the vision, from what we want to create, juxtaposed with current reality. While the distinction may seem small, the consequences are not. Many people and organizations find themselves motivated to change only when their problems are bad enough to cause them to change. This works for a while, but the change process runs out of steam as soon as the problems driving the change become less pressing. With problem solving, the motivation for change is extrinsic. With creative tension, the motivation is intrinsic.<sup>68</sup>

Thus, we see that a learning regulator is able to meet its organizational vision and, in doing so, also introduce efficiency into the environment subject to its oversight. We can state this in the alternative. The costs associated with the regulator's failure to become a learning regulator

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<sup>66</sup> Senge, "Leader's New Work."

<sup>67</sup> Ibid.

<sup>68</sup> Ibid.

are the failure to meet its organizational vision and the, consequential, failure to introduce efficiency into the regulated environment – failures that may undermine the legitimacy of the regulator.

A final dimension of the learning regulator framework to be discussed here is that of risk regulation. According to Bridget Hutter, “[r]isk regulation is inherently about the anticipation of risk and preventing its realisation.”<sup>69</sup> Martin Lodge identified four criticisms levied against regulators when things go wrong: (i) failure of imagination (“emphasizes how organizations ignore warning signs, fail to ‘connect the dots’, and do not account for ‘exceptional’ events”<sup>70</sup>); (ii) failure of initiative (“organizations and individuals are reluctant to exercise discretion, wait for confirmation and approval, and follow procedures when ‘action’ is required”<sup>71</sup>); (iii) over-imagination (organizations consider and respond to every potential risk, “which leads to substantial over-investment in the anticipation of low-risk events”<sup>72</sup>); and (iv) over-excitement (“politicians and regulators are said to be driven to react to media pressure by pronouncing on possible risks and their prevention early”<sup>73</sup>).

According to Lodge, contemporary regulatory discourse implicates lack of learning on the part of regulators and policymakers from past events and that “the ‘failure of imagination’ in terms of thinking about the future direction of risk regulation is particularly prominent.”<sup>74</sup> Lodge

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<sup>69</sup> Bridget M. Hutter, "Anticipating Risks and Organizing Risk Regulation: Current Dilemmas," in *Anticipating Risks and Organizing Risk Regulation*, ed. Bridget M. Hutter (Cambridge: Cambridge University Press, 2010), 17.

<sup>70</sup> Martin Lodge, "Editorial," *Risk & Regulation*, Winter 2011.

<sup>71</sup> Ibid.

<sup>72</sup> Ibid.

<sup>73</sup> Ibid.

<sup>74</sup> Ibid.

proposed that “[t]o address the inherent tensions and contradictions in risk regulation it is necessary to establish processes that enable reflection on contrasting definitions and estimations of particular problems and on how interventions are likely to trigger side-effects. Risk regulation is thus not about establishing supposedly ‘quick fixes’ that will prevent a particular event from happening.”<sup>75</sup>

Accordingly, we see that by adopting the learning regulator framework, regulators are able to adopt proactive longer-term strategies that allow them to deal with emerging issues in a manner that is both anticipatory and meeting the organization’s vision. This is achieved through the framework’s allowance for adaptation to emerging trends in the regulated environment, the tailoring of appropriate regulatory responses to such trends, and, thus, reducing the chances of these trends to pose a hazard to the regulatory framework and the regulated environment.

The positive implication of the learning regulator framework, from a risk regulation perspective, to regulatory agencies is that its adoption will enhance the public’s trust in the ability of the regulator to meet its vision. The negative implication of the learning regulator framework is that the regulator will not be able to address the negative side-effects of regulation, which, in turn, raises questions in the public’s minds about the legitimacy of the regulator.

## **2. The SEC as a Learning Regulator in the Pre-Crisis Era**

What are the implications of Strine’s<sup>76</sup> comments earlier (i.e., that legal models did not adapt to the realities at the level of the markets vis-à-vis the concentration of ownership into the hands of institutional investors) to the SEC’s ability to function as a learning regulator? While exploration

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<sup>75</sup> Ibid.

<sup>76</sup> Strine, "One Fundamental."

of this question is to be determined in the context of the SEC Proxy Access Rule, it is essential that we understand the agency's knowledge in relation to public firm ownership since the 1930s up to the time of the recent economic crisis.

It would appear that the SEC was aware of the institutionalization process which started in the 1950s and 60s. Once the agency became alert to the shift in equity holdings from retail investors to institutional investors, this knowledge gave rise to concerns at the Commission.<sup>77</sup> As a consequence, after several studies into the impact of institutional investors on the capital markets, the SEC introduced amendments to s. 13 of the 1934 Act in the form of s. 13(d), which required institutional investors to disclose their activity as a consequence.<sup>78</sup> In the 1990s, when the idea of proxy access was raised, some members of the Commission expressed concerns similar to those made in this article. For example, Commission Richard Roberts made the following comment:

Assuming small or institutional investors could not aggregate their shares to reach these thresholds, the foregoing proposals raise important issues of whether large shareholders should be treated more favorably under the proxy rules than other investors. While there is some attraction for a threshold de minimis level to provide a degree of seriousness to the proposal, the concept of discriminating against small shareholders is a particularly troublesome one.<sup>79</sup> [Emphasis in original]

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<sup>77</sup> Cohen, "An Address by Manuel F. Cohen, Chairman, Securities and Exchange Commission, before the American Bankers Association."

<sup>78</sup> David S. Ruder, "The Impact of Institutional Investors on Large Corporations" (paper presented at the 27th Annual Corporate Counsel Institute, Chicago, Illinois, October 11 1988).

<sup>79</sup> Richard Y. Roberts, "Proxy Reform - Guidelines For Review & Outlook" (paper presented at the The United Shareholders Association Foundation for Research and Education, Washington, D.C., June 7 1991), 8.

Thus, we see that the SEC had accumulated organizational knowledge vis-à-vis the evolving nature of public firm ownership and the consequences of institutional ownership to regulation and smaller non-institutional investors starting in the 1960s. Yet, two details qualify this awareness as only partial learning by the SEC.

First, while the SEC did display adaptability to the growing concentration of economic power into the hands of institutional investors by adopting such measures as the introduction of s. 13(d) of the 1934 Act, its overarching assumption vis-à-vis the nature of public firm ownership in the US was that it was characterized by the fragmented ownership structure. This issue is the one referred to by Strine<sup>80</sup> in the statement cited above. As such, despite the demographic shift in the ownership of public equity, the SEC's risk/danger analysis remained unaltered and premised on the understanding that (i) public firm ownership in the US was fragmented, (ii) fragmented owners were exposed to the risk of abuses by managers of public firms, and (iii) institutional investors (the emerging blockholder class) posed mere danger to fragmented owners.

This leads to a second observation – the SEC does not appear to have contemplated a revaluation or reassessment of the basic assumptions embedded in the 1934 Act vis-à-vis public firm ownership. That is, despite the fact that the Commission displayed awareness of, and has accumulated sufficient organizational knowledge about, the changing ownership demographics in the US capital markets, the Commission did not find it necessary to revisit the basic premise in US securities regulation – that the typical American public firm is characterized by dispersed ownership patterns – so as to (i) re-assess the validity of the original assumption, and (ii) update the original assumption based on the Commission's knowledge acquired since the 1950s and 60s vis-à-vis the growth of institutional investors.

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<sup>80</sup> Strine, "One Fundamental."



### 3. The SEC's (un-)Learning in the Post-2008 Crisis Era

We just saw that, prior to the 2008 economic crisis the SEC was able to display partial learning vis-à-vis the issue of corporate ownership. We need to determine whether the SEC was able to complete the learning phase and, thus, become a learning regulator in the post-crisis era.

The 2008 economic crisis presented regulators across different regulatory domains with social, economic, and financial challenges but also with opportunities. The challenges associated with the crisis stemmed from the fact that the crisis highlighted the vulnerabilities of modern society to the financial sector, the interconnectedness of economies across the globe, and the difficulties posed by the crisis to policymakers. The opportunities, which are still in the process of being realized, consisted of the chance to revisit existing regulatory models and updating them to reflect today's society (often necessitating doing away with old models that do not meet the needs of the present).

The crisis, which was attributed to the complexity of the financial markets,<sup>81</sup> resulted in heightened public and regulatory interest in increased regulation of the financial markets and the extension of regulation into new areas.<sup>82</sup> In the face of this pressure, the SEC was presented with two broad categories of reform (or strategic changes)<sup>83</sup> in order to deal with the lessons and

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<sup>81</sup> See, e.g., Schwarcz, "Leverhulme Lecture: The Global Financial Crisis and Systemic Risk".

<sup>82</sup> For a synopsis of events leading to the financial crisis and some of the initiatives adopted in response in various countries, see, e.g., IBA's Task Force on the Financial Crisis, "A Survey."

<sup>83</sup> A third option, a "do nothing" approach, was also available. The soundness and/or feasibility of this choice, however, were in all likelihood negated in light of the gravity of the circumstances created by the economic crisis (such as social and financial burdens).

implications of the crisis, which included, among other things, the mitigation of the impact of externalities such as systemic risk of the securities markets.

On the one hand, the SEC could have decided that it was a problem-solving organization adopting short-term strategies for the purposes of responding to immediate concerns with the hope of achieving rapid and tangible progress.<sup>84</sup> The adoption of this strategic choice, if we use Senge's terminology, would have signaled that the SEC deemed the issues raised by the crisis to be external to the agency, undesirable, and of such magnitude that the agency wished to get away from them. From the perspective of risk regulation this strategy qualifies as a quick fix that does not promote the integrity of the regulatory framework or adds to the stability of the regulated environment.

On the other hand, the Commission could have decided that it was a learning regulator adopting longer-term strategies able to meet short-term as well as longer-term demands.<sup>85</sup> The adoption of this proactive strategic choice would have signaled that that the issues raised by the crisis had elements that were both internal and external to agency and addressing them would allow the agency to meet its vision of becoming the investor's advocate.

It would appear that Schapiro was cognizant of the importance of adopting longer-term strategies in addressing regulatory shortcomings demonstrated by the recent economic crisis,

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<sup>84</sup> Masaaki Imai, *Kaizen: The Key to Japanese Competitive Success* (New York: Random House Business Division, 1986).

<sup>85</sup> Chris Argyris, *Overcoming Organizational Defenses: Facilitating Organizational Learning* (Boston: Allyn and Bacon, 1990); ———, "Teaching Smart People How to Learn," *Harvard Business Review* 69, no. 3 (1991); Senge, "Leader's New Work."; Ralph D. Stacey, "Strategy as Order Emerging from Chaos," *Long Range Planning* 26, no. 1 (1993).

given that such an approach would lessen the likelihood for the creation of regulatory gaps that would, in turn, translate into long-term imbalances in the regulatory system.<sup>86</sup> In professing to advocate this long-term view, Schapiro appeared to be signaling that the SEC is a learning regulator. Some commentators have suggested that Schapiro “saved the Securities and Exchange Commission from being regulated out of existence. Now she will be judged on what she can do to restore its role as investor guardian and promoter of fair markets.”<sup>87</sup> One “long-term” measure adopted by the Commission was the SEC Proxy Access Rule.

How does the SEC Proxy Access Rule fair, in terms of organizational knowledge building, relative to previous attitude expressed in the past by the SEC in relation to the ownership concentration in the US markets? The Rule would have (i) empowered this group of investors at the expense of other, minority investors, and (ii) amplified the minority shareholder-blockholder tension that is not addressed by the regulatory framework. As such, the Rule indicates an un-learning process within the organization in relation to previously accumulated organizational knowledge vis-à-vis the concentration of ownership into the hands of institutional investors and its potential implications to the markets.

Un-learning is apparent when we compare the comments made by members of the SEC (such as those made by Commissioner Roberts cited above) nearly twenty years ago on a similar proxy access proposal that was not adopted partly due to concerns with the negative impact of financial blockholders with the Rule. There is little empirical evidence to support such un-learning by the Commission. In fact, the evidence shows that the concerns over the concentration of equity holdings into the hands of institutional investors should be higher today than twenty

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<sup>86</sup> Schapiro, "Testimony Concerning Regulation of Systemic Risk 2009".

<sup>87</sup> Margolies and Younglai, "ANALYSIS-Schapiro gets US SEC out of crosshairs".

years ago.<sup>88</sup> Can changes in regulatory attitudes towards institutional blockholders account for such organizational un-learning?

The Rule, it can be argued, gave institutional investors who are the largest shareholders in many of Americans largest firms the opportunity to nominate directors thereby making boards more accountable to shareholders.<sup>89</sup> Thus, the SEC, this line of reasoning would hold, in recognition of ownership realities at the market level, adopted a rule that would empower today's blockholder for the purposes of introducing improvements into the governance framework of public firms. While one could argue that this qualifies for the "awareness" and "adaptability" elements of learning, the argument advanced here is that this is not the case. Two reasons account for this argument. First, if the SEC did decide to acknowledge the fact that the ownership structure in the US has changed toward a blockholder mode of ownership in manner

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<sup>88</sup> During this twenty year period, institutional investor assets have increased from 7.6 trillion in 1990 to over 27 trillion in 2006. Over the same period, institutional investors continued their long-term trend toward more aggressive equity investments while reducing their debt holdings. For example, in 1990 institutional investors committed 19.2% of their assets to equities, whereas by 2006 this figure has increased to 47.5%. Bond exposure, on the other hand, decreased from 44.6% of assets in 1990 231.5% in 2006. Brancato and Rabimov observed that institutional investors (in particular, activist state and local investors) "are devoting a relatively larger share of their assets to equities, which can be used as the basis for proxy voting to further their corporate governance agendas." Brancato and Rabimov, *2008 Report*: 4.

<sup>89</sup> See, e.g., comments of Richard Breeden, former Chair of the SEC in Senate Committee on Banking Housing and Urban Affairs, "Report of the Senate Committee on Banking, Housing, and Urban Affairs regarding The Restoring American Financial Stability Act of 2010," 146.

that merited a shift in regulatory thinking, such acknowledgment was absent from the text of the Rule. The second reason lies in Senge's "creative tension."<sup>90</sup>

The SEC Proxy Access Rule appears to represent the SEC's engagement in short-term strategies designed for the purposes of responding to immediate concerns with the hope of achieving rapid and tangible progress – that is, the SEC, through the Rule, was signaling that it is a problem-solving organization. The SEC Proxy Access Rule proposed to deal with issues external to the agency – corporate managers – by the introduction of a populist rule that would have public support at a time of great outrage against the financial sector and its captains. Such a response to public sentiments in the sphere of American policymaking is not new and can be traced as far as the 1800s (a time when the US capital markets were at their infancy), as the following excerpt illustrates:

There is perhaps no more congenial occupation for one interested in social movements than to trace the ebb and flow of public opinion on the economic questions that arise from time to time. Some striking fact will become known; a few enterprising newspapers will set the people to talking; politicians eager to make political capital out of every event will take the matter up, and bills will be introduced by the dozen into Legislatures ... Then, after the course of a few months, some other question seizes the public attention, and the first gradually fades in interest till news regarding it is given in brief commercial form.<sup>91</sup>

Yet, such an approach to policymaking is inappropriate to risk regulation and can only provide the policymaker with temporary gains while the long-term implications of such an approach are the downward pressure on the regulator's legitimacy.

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<sup>90</sup> Senge, "Leader's New Work."

<sup>91</sup> Jeremiah W. Jenks, "Trusts in the United States," *The Economic Journal* 2, no. 5 (1892): 70.

Moreover, in the context of the Proxy Access Rule, this approach resulted in the agency narrowing the creative gap between vision and reality by lowering its vision to the level of reality. This process of lowering vision to reality manifested itself by acknowledging that institutional investors are the reigning blockholders in the American equity markets capable of monitoring corporate managers. The cost, however, was that the Rule empowered institutional investors (thereby amplifying the minority shareholder-blockholder tension in the capital markets) and, as such, signaled that the vision of investor protection was the protection of financial blockholders.

Were the SEC to engage in learning, however, it would have realized that the governance issue to be resolved is a matter that is intrinsic to the SEC. While this would have required the SEC to overcome a cognitive hurdle,<sup>92</sup> it would have allowed the Commission to elevate reality to the level of vision. Here reality is that the regulatory framework does not adequately address the concern of all investors, and the vision is of the SEC being the investors' advocate. The difficulty, however, is that the SEC's vision of being the investor's advocate<sup>93</sup> appears to be somewhat ambiguous<sup>94</sup> and the Commission's fundamental assumption vis-à-vis ownership is that the US markets are, and have been since the 1930s, characterized by fragmented ownership. The inability to come to terms with these observations hinders the SEC's ability to learn and engage with the creative tension between reality and vision in a satisfactory manner.

To raise the reality in the capital markets to its vision, the Commission should have embraced the opportunity presented by the 2008 crisis to adopt a learning regulator framework

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<sup>92</sup> Argyris, "Teaching Smart People."; Senge, "Leader's New Work."

<sup>93</sup> SEC, "The Investor's Advocate".

<sup>94</sup> Khademian, *The SEC*.

for the organization and in doing so the Commission would have suppressed critics of its legitimacy and boosted the public's confidence in the regulator. In addition, this would have allowed it to remove the ambiguity associated with the identity of the investor on whose behalf it should advocate – that is, it would have been able to determine the identity of its client.

#### 4. Explaining the Failure to Learn

Historically speaking, learning was intended to be one of the hallmarks of the administrative process. This was expressed by James Landis in 1938:

With the rise of regulation, the need for expertise became dominant; for the art of regulating an industry requires knowledge of the details of its operation, ability to shift requirements as the condition of the industry may dictate, the pursuit of energetic measures upon the appearances of an emergency, and the power through enforcement to realize conclusions as to policy.<sup>95</sup>

That is the administrative agency, according to Landis, should possess expertise and responsiveness not found in government that would allow it to modify its policies and behavior based on emerging needs and demands posed by the regulated environment. Stated differently, Landis appears to have described the administrative agency as a learning regulator. In formulating the SEC Proxy Access Rule in its final form, the SEC showed that it is currently not meeting the intended goal of a responsive and adaptive regulator capable of generating rules that are relevant to the realities posed by the markets. One can propose several explanations for such failure.

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<sup>95</sup> Landis, *Administrative Process*: 23-24.

Carpenter,<sup>96</sup> for example, proposed that the reforms adopted by the Obama administration were the result of what he called institutional strangulation. Institutional strangulation “has come from a combination of veto points (the non-constitutional explosion of players who can say “no” to reform), gridlock (intransigence and obstruction among those operating American political machinery), and perhaps most importantly, bureaucratic politics (the jockeying among existing financial agencies and their associated correlations for turf and authority)”<sup>97</sup> [emphasis in original]. Institutional explanations, however, can only provide description of symptoms of ailments that affect the American system and do not illuminate on the epistemological issue of failure by regulators to engage in the learning process for the purposes of making rules that are relevant to the regulated environment.

Another possible explanation is that members of the SEC are unable to come to terms with the possibility that the regulatory framework contains an ownership distortion. This can be viewed as the defensive mechanisms displayed by individuals when faced with the possibility of an error in their cognitive reasoning with respect to decisions that allow them to perform routine operations.<sup>98</sup> It is this type of defensive mechanisms, however, that needs to be overcome if the organization’s leadership is to narrow the creative gap between its vision and reality and elevate reality to the level of vision.

A related explanation is the matter of avoidance by the SEC of two facts: (i) that institutional investors are a blockholder in the American markets,<sup>99</sup> and (ii) that the corporate

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<sup>96</sup> Carpenter, "Institutional Strangulation: Bureaucratic Politics and Financial Reform in the Obama Administration."

<sup>97</sup> *Ibid.*, 826.

<sup>98</sup> Argyris, "Teaching Smart People."

<sup>99</sup> Brancato and Rabimov, *2008 Report*.



model guiding regulation should be something other than the fragmented ownership model.<sup>100</sup> Pichhadze<sup>101</sup> called this new ownership model the Market Oriented blockholder Model (MOBM), which is a variant of the blockholder model in that it works with market mechanisms and can be found in market-based liquid economies such as the US. While interested observers (regulators and academics alike) are aware of the ownership distortion, many nonetheless advocate the maintenance of the current status quo.

For example, Brian Cheffins and Steven Bank pointed out, “[s]hare ownership likely became more widely dispersed following World War II, but studies of ownership and control carried out in the 1960s and 1970s offered only qualified endorsements of the separation-of-ownership-and-control thesis. The pattern revealed by more recent studies is similar.”<sup>102</sup> Despite this, Cheffins and Bank concluded that “while blockholders are by no means unknown, the typical very large firms lack a shareholder owning a dominant stake. The biggest companies are very much giants among their corporate brethren. As a result, the separation between ownership and control remain an appropriate reference point.”<sup>103</sup>

The following metaphor by Ulrich Beck illustrates the situation:

A society that conceives of itself as a risk society is, to use a Catholic metaphor, in the position of the sinner who confesses his or her sins in order to be able to contemplate the possibility and desirability of a 'better' life in harmony with nature and the world's

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<sup>100</sup> Strine, "One Fundamental."

<sup>101</sup> Pichhadze, "Market Oriented Blockholder Model."; ———, "Private Equity."; ———, "Regulatory Systemic Risk."

<sup>102</sup> Cheffins and Bank, "Is Berle a Myth," 467.

<sup>103</sup> Ibid.

conscience. However, few sinners actually want to repent and instigate change. Most prefer the status quo while complaining about that very fact, because then everything is possible. Confession of sins and identification with the risk society allow us to simultaneously enjoy the bad good life and the threats to it.<sup>104</sup>

The problem, according to Beck, is that in some cases (as in the case of the SEC), avoidance results in the introduction of risk by those charged with protecting society from risks. In the context of this article, "society" can be defined both narrowly and broadly. Narrowly defined, society means a body of passive investors in the capital markets that require government intervention for their protection from abuses by corporate managers. This was the expert's (i.e., the SEC) belief. However, as Anthony Giddens noted (albeit in the context of the sciences), "[t]he first principle of scientific advance is that even one's most cherished theories and beliefs are always open to revision. Science is thus an inherently sceptical endeavor, involving a process of that constant revision of claims to knowledge."<sup>105</sup>

What qualified as the SEC's scientific knowledge at the time of its creation were its views of the nature of ownership in the 1930s based on the empirical results of the study by Berle and Means. This "scientific" knowledge of the SEC remained "insulated," as Giddens<sup>106</sup> called it, in their effect on the broader society consisting of households and other members of the public that did not participate in the capital markets.

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<sup>104</sup> Ulrich Beck, "Risk Society Revisited: Theory, Politics and Research Programmes," in *The Risk Society and Beyond: Critical Issues for Social Theory*, ed. Barbara Adam, Ulrich Beck, and Joost van Loon (London; Thousand Oaks, Calif: SAGE Publications Ltd., 2000), 215.

<sup>105</sup> Anthony Giddens, "Risk and Responsibility," *Modern Law Review* 62, no. 1 (1999): 1.

<sup>106</sup> Ibid.

Society, however, has evolved. In order to avoid the social consequences of the Great Depression of 1929 social security reforms were undertaken to create a social safety net.<sup>107</sup> New actors in the capital markets were encouraged to participate in the economy in order to promote the social programs. Such actors included institutional investors, namely, pension funds and mutual funds. This resulted in two things: (i) the nature of public ownership has changed, and (ii) the society that the SEC was responsible for has broadened (covering savers, investors in funds, retail investors, and institutional investors).

The SEC's knowledge base in relation to the broadening definition of the society under its purview is reflected through many amendments to the 1933 and 1934 Act. Its basic definition of the nature of ownership in the US markets, however, does not appear to be different today than in 1934 and the regulatory gap created in the 1930s is equally unaddressed. Thus, we see that the incongruence between the agency's knowledge (i.e., perception of market realities) and market realities has expanded. It expanded through (i) the misclassification of the minority shareholder-blockholder tension as mere "danger" and (ii) the continuation of such misplaced classification in an era where it is no longer relevant.

The disparity between the agency's knowledge and market realities has expanded through avoidance of (i) the trend towards the MOBM, (ii) the impact of institutionalization on ownership, and (iii) the biases contained in the securities legislation or the quest to maintain the status quo. This expansion, however, allowed for the introduction of regulatory systemic risk – a species of systemic risk that arises in cases where there is misalignment between regulatory initiatives and market realities thereby creating regulatory gaps that become embedded in the

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<sup>107</sup> Naess, "Changing Patterns."

regulatory framework and affect multiple areas of the regulatory framework that governs the securities markets.<sup>108</sup>

In a sense, Pichhadze's regulatory systemic risk can be likened to Beck's "manufactured risk." As Beck explained, "[t]hese types of internal risks and dangers presume a threefold participation of scientific experts, in the roles of producers, analysts and profiteers from risk definitions. Under these conditions, many attempts to confine and control risks turn into a broadening of the uncertainties and dangers."<sup>109</sup> Thus, the SEC's (or the "scientific expert") preoccupation with the risk associated with the shareholder-manager tension, and attempts to curb this tension, elevated what was classified by policymakers as mere danger associated with the minority shareholder-blockholder tension to the level of risk within the fabric of the regulatory framework. To this risk, however, neither the SEC nor academic literature has established solutions or strategic plans. As Giddens cautioned, "[m]anufactured risk refers to new risk environments for which history provides us with very little previous experience."<sup>110</sup>

## V. CONCLUSION

The article questioned the ability of the Commission under its current leadership to engage in the process of learning through the lens of the SEC Proxy Access Rule. This epistemological issue was not addressed by many of the commentators on the Rule, who focused, instead, on matters relating to anticipated costs to market participants and efficiency implications of the Rule to the markets. The analysis showed that, currently, the SEC is not an agency capable of adapting to the

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<sup>108</sup> Pichhadze, "Regulatory Systemic Risk."

<sup>109</sup> Beck, "Risk Society Revisited," 216.

<sup>110</sup> Giddens, "Risk and Responsibility," 4.

changing and evolving nature of the markets subject to its oversight. This conclusion emerges from a review of the SEC Proxy Access Rule, which point to the SEC's failure to translate market-based evidence vis-à-vis corporate ownership into appropriate and meaningful legislation.

The analysis in this article contributes to the literature in several respects. First, from a legal history perspective, the analysis sought to explain the reasons for the introduction of an imbalance into the regulatory framework through an uncritical reliance and reading of Berle and Means' *The Modern Corporation and Private Property*, which resulted in the failure to address the minority shareholder-blockholder tension (prevalent in 77% of the listed firms at the time) while attempting to address the shareholder-manager tension (prevalent in 23% of the listed firms) via regulation. The explanations provided extend Pichhadze's<sup>111</sup> analysis on regulatory systemic risk and are based on investment theories advocated in the early decades of the 20th century, on the one hand, and sociological theories that offer insight into the risk/danger dichotomy relevant to policymaking, on the other.

The article's second contribution is to institutional and regulatory theories examining the performance of administrative agencies such as the SEC. To examine whether an agency achieves the objective of learning, the discussion in this article demonstrated the significance of contextualizing evidence on which policymaking is based for the purposes of avoiding the design of self-defeating policies that could be successfully challenged in the courts, thereby undermining the legitimacy of the administrative agency. The engagement in the learning process would also allow the regulator to narrow the gap between its vision and the reality within

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<sup>111</sup> Pichhadze, "Regulatory Systemic Risk."

which it functions. Currently, based on the SEC Proxy Access Rule experience, the SEC appears not to have a clear sense of either.

In addition, through its avoidance of the ownership problem in the equity markets, the SEC was able to introduce a form of manufactured risk. The trouble is that “as manufactured risk expands ... there is a new riskiness to risk.”<sup>112</sup> That is, new forms of risk (such as regulatory systemic risk) are introduced into the system. Such risks can only be addressed by the entity generating the risk – the regulatory agency itself. But appropriate address to this can only come if the regulator first realizes the situation.

From a comparative analysis stand point, the case study approach to the development of the learning regulator framework opens the doors for the analysis of other administrative agencies, which are similar to the SEC, for the purpose of exploring the role of variations and similarities in regulatory design. Such future analysis can take the form of cross-sectorial comparison between regulators from different domains, cross-national comparison between functionally equivalent regulators from different economies, or a combination of both.<sup>113</sup> This would increase our knowledgebase in relation regulatory approaches to risk regulation, identify various distortions embedded in different regulatory frameworks, and allow researchers to understand the reasons for such distortions and consider avenues to mitigating such distortions.

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<sup>112</sup> Giddens, "Risk and Responsibility," 4.

<sup>113</sup> David Levi-Faur, "Comparative Research Designs in the Study of Regulation: How to Increase the Number of Cases Without Compromising the Strengths of Case-Oriented Analysis," in *The Politics of Regulation: Examining Regulatory Institutions and Instruments in the Age of Governance*, ed. Jacint Jordana and David Levi-Faur (Cheltenham: Edward Elgar, 2004).

Future analysis into the ability of the SEC to meet its vision would benefit from an examination of when and why the SEC decided to engage in the process of un-learning vis-à-vis the organization's previously accumulated knowledge in relation to the implications of institutional investors' economic and voting power.

## **CHAPTER 7, CONCLUSION**

### **I. INTRODUCTION**

The study examined the relationship between markets and regulation, focusing on, and explaining why, certain assumptions about markets, actors, and systems came to be embedded in the regulatory practice in the American capital markets. More specifically, I examined regulatory assumptions about the nature of public firm ownership, the distortions that these assumptions introduced into the regulatory framework governing the securities markets, and the epistemological and risk-based implications of these distortions to actors, markets, and the regulatory system. The analysis adopted several approaches and methodologies including legal history, law and economics, comparative law, complexity/systems analysis, socio-legal analysis, and political economy.

The approach adopted for the evaluation of the SEC's performance took the form of a case study of a recent regulatory initiative – the SEC Proxy Access Rule. The uniqueness and suitability of the proxy rules for the purposes of analyzing the agency's performance rest in the fact that the regulation of the proxy rules is one of the agency's original responsibilities delegated by the legislator. As such, any deficiencies and excesses in the rules reflect directly on the SEC's performance. One factor that the Commission is required to consider, in the context of the proxy rules, is the dynamic nature of public firm ownership since regulatory instruments involving ownership are ultimately based on the regulator's understanding of the concept. In this sense, there exists a nexus between public firm ownership and regulation.



The method of addressing the issue of administrative agency's performance took the form of journal articles serving as building blocks for the purposes of presentation of ideas. The sequence of the individual chapters also follows the life cycle of the SEC Proxy Access Rule from the proposal stages in 2009 to the adoption of the final rule in August 2010. This enabled for a rich discussion around the nexus between public firm ownership and regulation and its implications to regulation, on the one hand, and the capital markets, on the other.

In this section of the volume, I summarize the main findings of the study and highlight the contributions that this study makes to the literature. In the final section of this Chapter, I provide some leads for future research.

## II. MAIN FINDINGS

The study expanded the rich literature on corporate governance in several respects. Adopting a historical approach to the area, the study found gaps in the regulatory framework governing the securities markets in the US. The gaps, which were introduced in the 1930s by the architects of the regulatory framework, resulted from a misreading of Berle and Means' *The Modern Corporation and Private Property*,<sup>1</sup> which led to a failure to appreciate that the real issue in American public firms at the time was the protection of minority shareholders from the potential abuse by blockholders or the minority shareholder-blockholder tension. This tension was evident in approximately 77% of the listed firms at the time. Rather than focus on this tension, policymakers focused on resolving the shareholder-manager tension found in 23% of the listed firms constituting American's largest firms at the time and displaying fragmented ownership.

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<sup>1</sup> Berle and Means, *Modern Corporation*.

The shareholder-manager tension focuses on protecting shareholders from abuses by unaccountable corporate managers. Two explanations are offered for this misplaced regulatory attention: (i) an investment theory explanation, which shows that the original securities regulation framework was designed to protect fragmented investors of modest means in large corporations that comprised Berle and Means' category of fragmented large public firms (where the shareholder-manager tension was prevalent); and (ii) a sociological risk/danger analysis, showing that the regulatory framework was designed to protect shareholders from abuses by management rather than from abuses by blockholders. The observation that the US markets in the 1930s were more appropriately characterized by blockholder ownership is supported by empirical evidence most recently summarized by Cheffins and Bank.<sup>2</sup>

While the regulatory framework's focus on the shareholder-manager tension gave rise to an imbalance within the framework, there was little reason for the SEC to either notice this imbalance or to be concerned about it. The reason is that the society subject to its purview was a simple one consisting of passive investors invested in large firms that require government intervention for their protection, on the one hand, and of risk-taking investors invested in smaller firms with blockholders capable of monitoring management and, therefore, do not require government intervention for their protection from abuses by management, on the other.

Society, however, has evolved. To avoid the social consequences of the Great Depression social security reforms created social safety-nets. To promote these programs new actors (i.e., institutional investors) were encouraged to participate in the economy. This had two outcomes: the nature of public ownership had changed, and the society that was subject to the SEC's

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<sup>2</sup> Cheffins and Bank, "Is Berle a Myth."

purview was broadened (covering savers, investors in funds, retail investors, and institutional investors).

The rise of institutional investors as blockholders in the American markets also means that the widely (and mischaracterized) accepted corporate model underlying US securities laws – the fragmented ownership model – should no longer valid and relevant for the purposes of policy analysis. The study argued that the ownership model that should be guiding policymakers in the US today is the Market Oriented Blockholder (MOBM). This ownership model incorporates the fact that, in the US, blockholders operate in liquid markets and with markets mechanisms such as takeovers. The fact that the MOBM incorporates blockholders and market mechanisms sets the model apart from traditional blockholder ownership models contemplated in the literature, in that the latter group is normally not associated with liquid markets.

In addition, the MOBM analysis has direct relevance to comparative corporate governance analysis and the divergence/convergence debate. The MOBM suggests that convergence on governance models is more feasible than currently contemplated in the literature. This also suggests that American policymakers should be looking at the experiences of their counterparts in economies traditionally characterized as blockholder economies such as the EU and Canada to see how to address concerns raised by block holdings. The lessons for policymakers outside the US from the MOBM analysis are equally important. Here policymakers should consider the contribution of transnational entities (such as American pension funds) to the corporate governance debate carefully given that these transnational entities make claims to the promotion of the diffusion of ownership in economies otherwise characterized as concentrated but , in fact, are promoting the concentration of economic and ownership power in fiduciaries.

The consequences of failure by American regulators to observe the ownership distortion in the regulatory framework and the trend toward the MOBM, as evident by the SEC Proxy Access Rule, exposes the markets to risk and raises epistemological concerns. From a risk perspective, the agency's avoidance of the regulatory gap and its amplification via the SEC Proxy Access Rule enabled the SEC to introduce into the regulatory framework a new form of risk into the financial system – regulatory systemic risk. Regulatory systemic risk arises in cases where policy decisions are based on policymakers' perceptions of market realities but such perceptions are inaccurate. Consequently, such policy initiatives introduce imbalance into the regulatory framework. In cases where the policymakers' perceptions relate to concepts that affect multiple areas of the regulatory framework, the error becomes systemic to the entire system. Consequently, regulatory systemic risk is a risk that is endogenous to the regulatory framework. Unfortunately, regulatory systemic risk is a new risk environment to which history provides little guidance in terms of solutions.

A related observation is that avoidance of the regulatory gap also points to epistemological concerns about the manner that the SEC is approaching policymaking. More particularly, the study argued that the agency does not have a clear understanding of its reality given that the rule was designed in a manner that further increases the minority shareholder-blockholder tension. A related matter was the SEC's inability to narrow the gap between realities ("where we are today") and vision ("where we want to be"). Here, reality is that the regulatory framework neither addresses the concern of all investors nor facilitates the SEC's vision of being the investors' advocate. The difficulty, however, is that the SEC's vision of being the investor's advocate appears to be somewhat ambiguous and its fundamental assumption vis-à-vis ownership is that the US markets are, and have been since the 1930s, characterized by

fragmented ownership. Tackling these difficult concerns would have allowed the Commission to stabilize the normative expectations of all investors, which at the moment are in a state of multiple-equilibrium points because different categories of investors can expect different treatment from the regulator depending on the outcome of the regulator's engagement in the public interest calculus. Addressing these difficult issues would have also suppressed critics of the Commission's legitimacy and boosted the public's confidence in the regulator in the post-crisis era.

### **III. IMPLICATIONS AND FUTURE RESEARCH**

The study focused on two narratives: that of ownership and that of regulation. The ownership narrative attempts to correct misconceptions in the literature about the nature of public firm ownership in the US. The regulation narrative develops a framework that is useful for the analysis of the performance of administrative agencies on individual, as well as, comparative bases for the purposes of understanding the role of variation in regulatory design and approaches to further our understanding of these agencies. The regulatory narrative also has utility for administrative agencies in that the learning regulator framework is an organizational learning model specifically designed to address the needs of administrative agencies in the execution of their tasks, thereby leading to both improved agency performance as well as shielding the agency's legitimacy and enhancing its reputation among audiences.

The ownership and regulation narratives offered in this study extend existing literature, and provide a platform for future research, at three levels: international, transnational, and domestic. From an international perspective, as already noted in the previous section of this chapter, the fact that the US is characterized by the MOBМ paves the way for reinvigorating

studies relating to the convergence/divergence debate in the area of corporate governance. The MOBM analysis suggests that convergence in the corporate governance area is far more feasible than previously thought as economies, such as those in Europe are moving toward the MOBM.<sup>3</sup> This also invites the examination of how many, and which, economies display the MOBM. It is arguable, for example, that the Canadian and UK markets can be said to be represented by the MOBM. The implications of this assertion to the regulatory framework governing each of these economies should be examined for the purposes of enhancing market efficiency and investor protection.

On the matter of investor protection in the comparative international context, one study that would benefit from re-visitation is the often cited study by La Porta et al.<sup>4</sup> That study examined, among other things, the impact of ownership concentration on shareholder protection, and found a negative relationship between ownership concentration and investor protection. Since the study by La Porta et al was published in 1988, however, institutional holdings in America's 1000 largest firms in the US have gone up from 46.6% in 1987 to 76.4% in 2007. Updating La Porta et al's study based on new data is likely to also update their conclusions and stir the corporate governance discourse in new directions. Another update to the study by La Porta et al. was suggested by Puri who noted that the study does not take into account regulatory structures and securities law rules but rather focuses on corporate law rules.<sup>5</sup> Updating the La

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<sup>3</sup> Gaëtane Schaeken Willemaers, *The EU Issuer-Disclosure Regime: Objectives and Proposals for Reform*, International banking and finance law series (Alphen aan den Rijn, Netherlands; Frederick, MD: Wolters Kluwer Law & Business, 2011).

<sup>4</sup> La Porta et al., "Law and Finance."

<sup>5</sup> Poonam Puri, "Legal Origins, Investor Protection, and Canada ", *CLPE Research Paper No. 03/2010*(2010), <http://ssrn.com/abstract=1556986>

Portra et al. study, according to Puri, is significant for two reasons: (i) it shifts focus from investor protection concerns associated with private companies (corporate law focus) to investor protection concerns associated with public companies (securities law focus), and (ii) its shifts focus from court protection to “securities regulators’ actions [which] are arguably more important in certain instances in ensuring investor protection.”<sup>6</sup>

From a regulatory perspective, Anand, for example, suggested that the recent economic crisis showed that securities regulators need to be cognizant of systemic risk considerations to the markets.<sup>7</sup> These suggestions have support from such rule-setting entities as the International Organization of Securities Commissions (IOSCO).<sup>8</sup> IOSCO’s definition of systemic risk “places securities regulators front and center as primary contributors to the reduction of systemic risk,”<sup>9</sup> according to Condon. Such focus, while may be challenging to domestic regulators,<sup>10</sup> offers interested observers an opportunity to consider how the learning regulator framework can, and should, be introduced to securities regulatory frameworks so as to address both (a) external types of systemic risk contemplated by IOSCO, as well as, (b) endogenous types of systemic risk, such as regulatory systemic risk, identified in this study.

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<sup>6</sup> Ibid., 18.

<sup>7</sup> See, e.g., Anita Anand, "Is Systemic Risk Relevant to Securities Regulation?," *University of Toronto Law Journal* 60, no. 4 (2010).

<sup>8</sup> Mary Condon, "Products, Perimeters and Politics: Systemic Risk and Securities Regulation," in *The Embedded Firm: Corporate Governance, Labor, and Finance Capitalism*, ed. Cynthia A. Williams and Peer Zumbansen (Cambridge: Cambridge University Press, 2011).

<sup>9</sup> Ibid., 448.

<sup>10</sup> Ibid., 457-58.

From a transnational perspective, the role of institutional investors in the governance discourse should be re-visited. Future research in this context should look into the role that these investors play as transnational actors in the global corporate governance debate. Specifically, future research would focus on the conflicted agenda that these investors appear to promote in the global governance debate. The conflict arise from the claim that these investors are promoting the cause of diffused ownership as a beneficial form of ownership structure, on the one hand, and the fact that these investors are the new blockholder in the markets. The analysis will re-evaluate lessons generated from studies conducted in the 1990s vis-à-vis institutional investors and would update their conclusions against the background of the MOB analysis.

A related matter is Zumbansen's claim that the corporate governance debate, in general, and the corporation, in particular, has become a matter of transnational consideration.<sup>11</sup> When we juxtapose the learning regulator framework against the pluralistic nature of the corporate governance debate suggested by Zumbansen, we see the evermore significance of the need for regulators' to be able to maintain sight of their regulatory vision for the purposes of being able to meet their mission. The importance of this observation lies in the fact that while various actors in the debate have interest in regulatory outcomes, many do not shoulder the onus of protecting investors – that onus, and the blame for failing to meet it, is carried by the regulator alone. The flip-side of this observation is the question of how regulators should proceed in maintaining their vision while taking into account the dynamic (and plural) socio-economic reality demonstrated by the regulated environment subject to their oversight. Engagement in this calculus will take the

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<sup>11</sup> Peer Zumbansen, "Corporate Governance, Capital Market Regulation and the Challenge of Disembedded Markets," in *Corporate Governance and the Global Financial Crisis: International Perspectives*, ed. William Sun, Jim Stewart, and David Pollard (Cambridge: Cambridge University Press, 2011).



discussion of the learning regulator offered in this study to a new level of complexity but would allow for the consideration of variables impacting the domestic, transnational, and international regulatory arenas.

From a US domestic perspective, the suggestion that the SEC, based on the SEC Proxy Access Rule experience, is engaging in the process of un-learning organizational knowledge that viewed institutional investors as blockholders creates the venue for future research seeking to analyze at what point in time, and why, the agency dropped its suspicion of institutional investors as an economic power in favor of one that views these investors as promoting the welfare of all the stakeholders (including shareholders) of the corporation, despite evidence of the short-term investment horizon of this group of investors.

In the Canadian context, the discussion in this study offers several points for consideration. Russell and Waitzer, for example, have argued that Canadian securities regulators are failing to introduce efficacy into the Canadian markets by failing to adequately adapt the regulatory framework to the realities of the Canadian marketplace.<sup>12</sup> In addition, Vanderpol and Waitzer suggested that the public interest jurisdiction of Canadian securities regulators, which is based upon the objectives of securities regulation, investor protection, and market efficiency, is broad and ambiguous.<sup>13</sup> In addition to challenging the reputation and legitimacy claims of

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<sup>12</sup> Ian Russell and Edward Waitzer, "Overcoming Securities Regulation Lock-in," *Investment Executive*, no. 12027405 (2012).

<sup>13</sup> Sean Vanderpol and Edward Waitzer, "Time to Rethink Poison Pills; The Question is Are They Still in Public's Interest?," *National Post* 2011. They also suggested that the courts are better equipped than securities regulators in analyzing the conduct of boards of directors. Sarra suggested that "while examples of this potential role of the courts are limited to date, this notion that the courts could depart from a more ex post rights-based interpretive role

Canadian securities regulators, these arguments suggest that Canadian regulators are also vulnerable to the criticism of failing at being learning regulators. As such, analysis of Canadian securities regulators using the learning regulator framework would be of great value for the purposes of (i) determining the performance of each of the provincial regulators and (ii) conducting a comparative analysis between the different regulators in order to gain insight from variations vis-à-vis the performance of various regulators.

The Canadian discourse vis-à-vis the proxy process should also be mentioned here. Canadian corporate laws allow shareholders to nominate directors on the corporate proxy ballot.<sup>14</sup> The proxy mechanism, as some concerned observers noted,<sup>15</sup> is not without its faults suggesting, for example, the introduction of technology-based solutions for individual shareholders gaining proxy access. While the consideration of suggestions for the improvement of the current system are welcome, caution should be exercised in ensuring that such suggestions remain tailored to the realities of the Canadian marketplace and avoid the importation of biases and errors from other jurisdictions in order to avoid the introduction of unnecessary regulatory systemic risk into the Canadian markets (which would place unnecessary negative pressure on the reputation and legitimacy of Canadian securities regulators).

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to a facilitative role is intriguing," in Janis Sarra, "New Governance, Old Norms, and the Potential for Corporate Governance Reform," *Law & Policy* 33, no. 4 (2011): 587.

<sup>14</sup> See, e.g., Christopher C. Nicholls, *Corporate Law* (Toronto: Emond Montgomery Publications, 2005). 267-70.

<sup>15</sup> See, e.g., Carol Hansell et al., "The Quality of the Shareholder Vote in Canada," (2010), <http://www.dwpv.com/shareholdervoting/Download.htm>.

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