DOES LAW MATTER?: THE SEPARATION OF OWNERSHIP AND CONTROL IN THE UNITED KINGDOM

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Abstract

The corporate world today subdivides into rival systems of dispersed and concentrated ownership, with different corporate governance structures characterising each. The United States and the United Kingdom fall into the former category and other major industrial countries tend to fall into the latter. There is anecdotal evidence that suggests market forces are serving to destabilise traditional structures and cause some form of convergence along American corporate governance lines. According to some corporate governance experts, a variable that will affect how far matters will progress is the law. They argue that because the law "matters", a transition to the US pattern of corporate governance will occur only gradually and tentatively unless there is a legal environment which is hospitable to dispersed share ownership.

This paper provides evidence on the extent to which legal regulation does "matter" in the corporate governance context. The approach is historical in orientation and the focus is on the emergence of a separation of ownership and control, characterised by widely dispersed share ownership and strong managers, in the United Kingdom. The experience in Britain is instructive because, with respect to corporate governance, no other major industrial nation has more in common with the United States. Developments in the UK suggest that a highly specific set of laws governing companies and financial markets do not have to be in place to ensure that a separation of ownership and control becomes a central feature of a country's corporate governance system. Instead, alternative institutional structures can perform the function "law matters" advocates say the legal system needs to play. It is an open question, however, whether such alternatives are likely to emerge in countries where a transition to the American pattern of corporate governance could be in progress.

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1. Introduction

Does law matter? Traditionally, legal scholars have taken for granted that it does. The conventional wisdom has been that members of society attempt to comply with legal rules and alter their behaviour when laws are changed. Academics, however, no longer accept this proposition at face value (Cheffins, 1997: 24). Since the 1960s, conceptual approaches drawn from the social sciences and the humanities have increasingly been imported into and made the basis of legal analysis (Cheffins, 1999*a*: 201-2). Coincident with this trend, legal scholars have recognised that law is only one constraint that regulates behaviour. Others include markets, which regulate through the device of price, and social norms, which constrain because of enforcement by the community (Lessig, 1998: 662-63).

Some legal scholars have not simply recognised that law is only one constraint that regulates behaviour. Instead they have sought to downplay its significance in relation to other factors. For instance, various practitioners of "law and economics" assert that market forces do a more effective job of regulating than does the legal system (Lessig, 1998: 665). Similarly, among those who have analysed the role of "norm behaviour", some have argued that a community's customary norms should be accorded substantial deference (Posner, 1996: 1697, n. 2; Katz, 1996: 1746, discussing Ellickson, 1991; Cooter, 1996). Within the legal academy, however, those who acknowledge that law is only one constraint that regulates behaviour do not necessarily accept that the legal system's role is or should be marginal. Instead, many take the view that state institutions such as courts and legislatures can affect the operation of the market and the functioning of norms and do so in a way that improves upon the outcome that would otherwise be reached (Lessig, 1998: 666; Katz, 1996: 1746-47, discussing Posner, 1996, Eisenberg, 1999: 1270-71, 1274, 1277-78, 1291).[1]

Corporate governance, in its comparative dimension, constitutes an important area where the role of the law has become the subject of intense debate. Comments made by two leading experts on corporate law are illustrative. Easterbrook has observed that "international differences in corporate governance are attributable more to differences in markets than to differences in law (1997: 29)". Coffee, writing about the prospects for global convergence in corporate governance, has advanced a claim that is "novel only to the academic world: law matters (1999*a*: 707; see also Coffee, 1999*b*: 1-2)."

The role that law plays in the corporate governance area is not merely a topic of academic interest. The corporate world today subdivides into rival systems of dispersed and concentrated ownership, with different corporate governance structures characterising each (Coffee, 1999*b*: 2). The United States falls into the former category. Its economy is dominated by large, publicly quoted corporations run by professional managers and owned by widely dispersed shareholders that buy and sell equity in highly liquid, well-developed securities markets. There is anecdotal evidence that suggests market forces are serving to destabilise traditional structures and cause some form of convergence along American corporate governance lines (Bratton and McCahery, 1999: 233-37; Coffee, 1999*a*: 663-67, 671-82). A variable that could affect how far matters will progress is the law. If Coffee is right and the "law matters", then the existence of a legal environment which is hospitable to dispersed ownership should hasten the transition process. On the other hand, if a country's legal regime does not offer favourable conditions for the emergence of this type of corporate governance structure, then the prospects for convergence along American lines will be diminished (Coffee, 1999*a*: 654-57; Bebchuk and Roe, 1999: 137-38, 142, 153, 163; Roe, 1998: 344).

The purpose of this paper is to provide some evidence on the extent to which legal regulation in fact does matter in the corporate governance context. The approach used here will be an examination of the emergence of the paradigm American corporation, with its strong

managers and widely dispersed shareholders, in the United Kingdom. The experience in Britain is instructive because, with respect to corporate governance, no other major industrial nation has more in common with the United States. On balance, developments in the UK suggest that a highly specific set of laws governing companies and financial markets do not need to be in place for the American version of corporate governance to become predominant. Instead, alternative institutional structures can perform the function "law matters" advocates say the legal system needs to play. It is an open question, however, whether such alternatives are likely to emerge in countries where a transition to the American pattern of corporate governance could be in progress.

The paper proceeds as follows. An overview of the "law matters" thesis will be set out in section 2. Section 3 will draw attention to links between the British and American systems of corporate governance. The emergence of a separation of ownership and control in the UK will be described in section IV. I will assess in section 5 the extent to which the law "mattered" in the first half of the 20th century in the UK. Section 6 will do likewise for the latter half of the century. Section 7 will offer a brief conclusion.

2. The "Law Matters" Thesis

2.1 Intellectual Foundations

The corporate governance arrangements which exist in the United States have been characterised as an "outsider" or "arms-length" system (Berglöf, 1997: 152, 157-64; Goergen, 1998: 1-2). The "outsider" typology is apt because share ownership is widely dispersed instead of being concentrated in the hands of families, banks or other firms. Most of the country's major companies have publicly traded shares and few of these have a shareholder that owns enough equity to have any sort of "inside" influence. Instead, large shareholdings, and especially majority ownership, are uncommon (Shleifer and Vishny, 1997: 754; La Porta, *et al.*, 1999: 491-97).

The term "arms-length" is suitable in the US context because shareholders maintain their distance and give executives a free hand to manage. This approach prevails because in the ordinary course investors are more concerned with the overall performance of the portfolio of shares they own than they are with developments affecting any one particular company. There admittedly has been a well-chronicled increase in institutional activism in the past decade (Smith, 1996: 1104-5). Still, since such intervention has generally been restricted to "crisis" situations (Smith, 1996: 1105-6), it is fair to say to say that shareholders in American public companies are rarely poised to intervene and take a hand in running the business.

In *The Modern Corporation and Private Property,* "the most important study ever written about the ownership and governance of the American business corporation" (Mark, 1995: 973), Adolf Berle and Gardiner Means (1932) drew attention to the pattern of corporate governance which prevails in the US. They pointed out that, while the law treated stockholders as a company's owners, those investing in public corporations left it to professionally trained executives to deal with matters of importance. The normative implications of this "separation of ownership and control" were widely debated in the decades that followed, but interested observers implicitly agreed on an important point: fragmented share ownership was inevitable in major business enterprises (Mark, 1995: 973-76).

According to the prevailing orthodoxy,[2] technology dictated that dominant firms must be large. Dispersed ownership followed because the capital needs of big companies were so great that a handful of wealthy individuals could not provide proper financial backing. Also, a separation of ownership and control was beneficial since executives could be hired solely on the basis of their managerial credentials. This could occur because managerial recruits would not be expected to make any sort of financial contribution to the firm hiring them or to have any sort of connection with key shareholders (e.g. as a member of a family owning a substantial block of equity).

Corporate governance in Japan and in most countries in continental Europe is organised on a much different basis than it is in the US. Publicly quoted companies do not play as nearly as important a role in the economy (La Porta *et al.*, 1997: 1137-38). Also, "core" shareholders and/or dominant creditors monitor corporate activities closely and are well-situated to exercise considerable influence over management. The prevailing approach to corporate governance therefore is "insider" or "control-oriented" (Berglöf, 1997: 157-64; Hoshi, 1998: 851-66).

During the 1970s and 1980s, the insider/control-oriented versions of capitalism existing in Germany and Japan seemed to be delivering better performance than their market-oriented counterpart in the US. This led some to question whether the separation of ownership and control in the US was an historical accident rather than the product of fundamental economic logic (e.g. Roe 1990; 1994; 1997). However, the economic trends of the 1990s served to give the Darwinian account of corporate governance renewed vitality. The American version of capitalism again was dominant, which implied that the "Berle-Means" corporation was in fact delivering the efficiencies that economic theory implied it should (Hansmann and Kraakman, 2000: 16-17). Also, the fact that companies in countries with insider/control-oriented systems of ownership and control were beginning to move toward the stock market (Coffee, 1999*a*: 665; Abrahams, 2000) and to unwind complex cross-shareholding arrangements (Mindset, 1999, Lean, Mean, 2000: 17-18) implied that an evolutionary drive toward efficient structures was taking place (Hansmann and Kraakman, 2000: 17-19). As the chairman of Credit Lyonnais SA, a privatised French bank, said in a 1999 interview, "we're going through a Darwinian evolution of the species" (Kamm, 1999).

As economic trends drew attention to the relative efficiency of the American way of doing business, a question arose: why did the insider/control-oriented system of corporate governance persist in so many countries? Darwinian economic logic, after all, seemed to

dictate an inevitable convergence along American lines (Coffee, 1999*a*: 646, 653). An explanation that quickly gained adherents was that the "law matters". Various economists and academic lawyers have hypothesised that corporate governance did not evolve along American lines because the appropriate legal framework was not in place (e.g. Modigliani and Perotti, 1998, Coffee, 1999*a*; Coffee, 1999*b*; Johnson and Shleifer, 1999; Scott, 1999; Black, 1999).

A series of studies carried out by La Porta *et al.* (1997, 1998, 1999) gave the "law matters" story a powerful empirical boost (Coffee, 1999*a*: 644). They studied the legal systems of 49 countries and classified each as being a "common law" jurisdiction (those following judicially-oriented English legal traditions) or a "civil law" jurisdiction (those following a scholar and legislator-made tradition dating back to Roman law). They found that common law countries are significantly more protective of shareholders than civil law countries, have better developed capital markets and have significantly more widely held firms per capita. The message suggested by these results was that ownership concentration is a consequence of poor legal protection of minority shareholders.

2.2 Which Laws "Matter"?

In an unregulated environment, there is a real danger that a public company's "insiders" (controlling shareholders and senior executives) will cheat outside investors who own equity. There are several ways that this might be done (Cheffins, 1999*c*: 33-34; Fox and Heller, 1999: 18-22). The most flagrant method is outright looting of assets, where those controlling a company will effectively transfer cash or property into their own hands (Fox and Heller, 1999: 21). Another way that insiders can "hollow out" a public company is to engineer "sweetheart" deals with related parties in order to siphon off a disproportionate share of the firm's earnings (Coffee, 1999*b*: 23). Those controlling a company also might cheat outside investors by arranging to purchase or sell shares on favourable terms not otherwise made available (DeMott, 1997: 333-34). Moreover, insiders might

orchestrate a "going private" transaction (i.e. sever links to public securities markets by eliminating all outside investors) and "squeeze out" the minority at an unfairly low price (O'Neal and Thompson, 1997, para. 5.04).

According to the "law matters" story, in a country where the law offers little protection against cheating by insiders, potential investors will fear exploitation. Correspondingly, unless it is possible to invest through the protective medium of a substantial block, they will shy away from buying shares (Coffee, 1999*a*: 644, 647). Insiders, being aware of such scepticism, will decide not to sell equity to the public (Black, 1999: 20-21). They will opt instead to retain the private benefits of control and rely on different sources of finance, even if they have to forego pursuing potentially profitable opportunities in so doing (Scott, 1999: 7-8, 11-12). The Berle-Means corporation will therefore not become dominant.

The outcome may well be different if a country regulates opportunistic conduct by insiders. Minority shareholders will feel "comfortable" in this sort of "protective" jurisdiction (Roe, 2000: 47), which means that investors should be willing to pay full value for shares made available for sale (Coffee, 1999*a*: 644). This, in turn, should lower the cost of capital for a firm that chooses to sell equity in financial markets. Public offerings of shares can be expected to follow.[3] Once such dynamics operate on a collective basis, a country has the potential to develop a vibrant stock market and a widely dispersed pattern of share ownership (Black, 1999: 2-3).

What sort of legal regime needs to be in place for minority shareholders to feel "comfortable"? A helpful starting point is a fair and reliable judicial system (Black and Kraakman, 1996: 1926, 1940-41; Scott, 1999: 13; Black, 1999: 16, 25). If judges are corrupt, the courts have inadequate resources and judicial procedures are cumbersome, investors will have little confidence that their legal rights offer meaningful protection. Hence, as the current situation in Russia illustrates, if law is so weak that even basic contracts cannot be

enforced, establishing complex corporate institutions is very difficult (Roe, 2000: 51-52). The prospects are considerably more promising if there is a properly functioning judicial system. Indeed, there is empirical research which suggests that a strong correlation exists between the strength of a country's law and order tradition and the size of its equity markets (La Porta, *et al.,* 1997: 1141-42, 1146).

Assuming that there is a fair and reliable judicial system in place, various types of legal rules can potentially favour minority shareholders against insiders and thereby improve the "comfort level" for outside investors. The regulation of voting rights attached to shares is one example cited by those who have staked out the "law matters" position. The thinking is that if the law does not restrict the use of shares with weighted voting rights, minority shareholders can face an unpalatable outcome: insiders will retain control of a firm without having substantial ownership of outstanding stock (La Porta *et al.*, 1998: 1126-27). Also potentially significant are pre-emptive rights, which oblige a company issuing new shares to give existing shareholders the opportunity to purchase a proportion of the equity equal to the percentage of shares they already own. This sort of right can serve to protect investors from prejudicial dilution of their stake in a company, such as when shares are issued to insiders at below-market prices (La Porta *et al.*, 1998: 1126).

A director's duty of loyalty is another type of legal rule "law matters" advocates have identified as being potentially important (Shleifer and Vishny, 1997: 751-52; Black, 1999: 22, 24-25; Scott, 1999: 12-13). In general, when this sort of duty applies, it will require those making decisions on behalf of a company to put the shareholders' interests above their own if these are in conflict (Scott, 1999: 13). A key feature of a duty of loyalty will be legal restrictions on managerial self-dealing, which should cover not only outright theft and misappropriation but also excessive consumption of managerial perks and "sweetheart" deals between insiders and the company (Shleifer and Vishny, 1997: 752; Scott, 1999: 13).

Giving minority shareholders legal mechanisms to contest perceived oppression by those controlling a company constitutes an additional means by which the confidence of outside investors can be enhanced (LaPorta *et al.*, 1998: 1128). US corporate law provides various potential examples. A minority shareholder can, under prescribed circumstances, call directors, officers and controlling shareholders to account for mismanagement, diversion of assets or fraudulent manipulation of corporate affairs by commencing litigation on behalf of the company (a "derivative" suit) (Cox *et al.*, 1995: §15.2). Shareholders typically have "appraisal" rights which enable them to vote on specified fundamental changes (e.g. a merger or major asset sale) and permit them to demand a buy out of their shares at fair value if such changes are implemented against their wishes (Committee on Corporate Laws, 1993: §13.02). Also, various US states permit individual shareholders to apply for relief on the grounds that the affairs of the corporation are being conducted in a manner which is oppressive or unfairly prejudicial to them (O'Neal and Thompson, 1997, §§7.14, 7.15).

Laws prohibiting insider dealing might also serve to make investors feel comfortable about investing in companies. The logic involved is that the possibility of being outfoxed by better-informed insiders makes shares riskier for outsiders. Correspondingly, without legal regulation, investors will not be willing to pay as much for equity, or may not buy at all (Cost, 2000). Empirical research illustrates that there is a correlation between insider dealing regulation and diffused share ownership. Beny (1999) found in a study of 33 countries that firms in jurisdictions with tough sanctions have more widely dispersed share ownership structures than those in countries with lax regulation.

Regulation of disclosure by companies that issue shares to the public is one further technique that can be used to enhance investor confidence (Black, 1999: 4-6, 8, 10-11). The scope for beneficial state intervention exists because securities markets can constitute a "market for lemons", based on Akerlof's original example of used cars (1970).

To elaborate, the value of a company's shares depends on the company's future prospects. In order to assess future prospects, investors need credible information. Without it, they will not be able to distinguish between "high-quality" companies and their "low-quality" counterparts. Investors, realising their predicament, will discount the prices they will offer for the shares of all firms. High-quality companies, in turn, will not receive fair value for their shares, thus providing them with an incentive to forsake any involvement with the stock market. As high-quality companies get driven from the market, investors will react by discounting still further the prices they will pay. Ultimately, the outcome will be a discredited and unpopular stock market.

The introduction of disclosure regulation can potentially provide a solution to the "lemons" problem just described. If the law requires companies to provide a wide-range of information when they first go public and imposes continuous disclosure obligations thereafter, it will become easier for investors to distinguish high-quality companies from their less meritorious counterparts. The investing public should in turn become willing to pay more for shares with genuinely promising prospects. When high-quality firms begin to receive support from investors, they will then carry out public offerings with increasing regularity. As the process continues, the stronger a country's securities market becomes. At the same time, a suitable economic platform will have been established to allow the Berle-Means corporation to become dominant.

3. The British Experience and its Relevance for the "Law Matters" Thesis

As we have seen, the corporate world today subdivides into rival systems of dispersed and concentrated ownership, with the United States falling into the former category and most other major industrial countries falling into the latter. The US has a companion, however, in the dispersed ownership category, this being the United Kingdom. Britain, like the US, has an "outsider" or "arms-length" system of

ownership and control (Stapledon, 1996: 3-4; Cheffins, 1999c: 11-13).

In Britain, as in the United States, the "outsider" terminology is appropriate because share ownership is widely dispersed. The British economy is dominated by companies which have carried out public offerings of shares (Moerland, 1995: 19; Franks and Mayer, 1997: 283); the country in fact has more public companies per one million people than does the United States (La Porta *et al.,* 1997: 1137). Moreover, it is uncommon for British public companies to have a dominant shareholder (Davies, 1997b: 48; Wymeersch, 1998: 1170-72). Part of the reason for this pattern is that families rarely own a substantial percentage of shares in large UK companies (La Porta *et al.,* 1999: 501, Table V; Faccio and Lang, 2000: 2, 17-20). Also, while UK institutional investors own approximately 70 per cent of the equity in the country's public corporations, an individual financial institution is unlikely to control more than 5 per cent of the equity in any one firm (Stapledon, 1996: 106-17; Cheffins, 1997: 64, 634).

The "arms-length" label is suitable for the UK because the country's shareholders act in the same manner as their US counterparts and generally take a "hands-off" approach with companies they own. Take the example of British institutional investors. Traditionally, they prefer to leave it to professionally trained executives to run companies and respond to poor corporate performance by selling their stake rather than by intervening in order to try to rectify matters (Cheffins, 1997: 63-64). Institutional investors usually only become deeply involved in a company's affairs when the incumbent management team has been fully discredited and they always prefer to act on a quiet, "behind the scenes" basis (Stapledon, 1996: 101-6, 121-24; Cheffins, 1997: 64, 616-17, 620).

Again, the "law matters" thesis implies that a country has the potential to develop a vibrant stock market and a widely dispersed pattern of share ownership if its legal system regulates cheating and other opportunistic conduct by corporate "insiders". This is because

minority shareholders feel "comfortable" in a "protective" jurisdiction, which serves to create a hospitable environment for firms seeking to carry out public offerings of shares. The British experience with the widely held public company provides an opportunity to test the foregoing proposition. If the law was a pivotal factor in the UK, one would expect to find that when Britain's outsider/arms-length system of ownership and control was taking shape, the country's legal regime would have favoured minority shareholders against managers and dominant shareholders. In order to gain a sense of whether this did transpire, it is necessary first to ascertain when a separation of ownership and control became well-established in the UK. The next section of the paper surveys this issue.

4. The Berle-Means Corporation in the UK: A Chronology [4]

Though the UK had established itself as the world's first industrial nation and consumer society as the 19th century was coming to a close (Chandler, 1990: 251), the country did not yet have a sophisticated corporate economy. As late as the 1880s, only 5 to 10 per cent of Britain's larger business enterprises had incorporated (Hannah, 1976: 19; Payne, 1978: 195). Moreover, at this juncture there were barely sixty domestic commercial and industrial companies with shares quoted on London's Stock Exchange, accounting for hardly one per cent of all quoted securities (Prais, 1976: 90). London was the unrivalled financial centre of the world and its Stock Exchange was the central element in an integrated world securities market (Cassis, 1990: 1; Michie, 1992: 134). Still, London's Stock Exchange was a market dealing primarily in government debt and, to a lesser extent, railway bonds (Michie, 1990: 96-99; Kennedy, 1994: 125, 127-30).

As we have just seen, most large British business enterprises are now publicly quoted. The move towards the stock market began in earnest in the final few years of the 19th century and continued in the years thereafter. By 1907 almost 600 domestic commercial and industrial companies were quoted on London's Stock Exchange (Hannah, 1976: 20; Armstrong, 1990: 118-23). Aside from disruptions imposed by

war, the number approximately doubled in each decade thereafter until a peak of about 3500 companies was reached in 1951 (Prais, 1976: 90).[5] Publicly traded firms, in turn, became a dominant force in the economy. By the middle of the 20th century they accounted for over 70 per cent of the profits generated by the British corporate sector (Hannah, 1974: 65).

The move towards the stock market served to transform UK capital markets. In the years immediately prior to the beginning of World War I (1914), British companies accounted for approximately one-third of the funds raised on London's Stock Exchange (Thomas, 1978: 24). By the mid-1930s, well over 50% of the "new issue" marketwas concerned with the finance of domestic firms and the percentage exceeded 90% in the years following World War II (Thomas, 1978: 24, 145).[6] Ultimately, by 1972, company securities accounted for four-fifths of the value of all securities quoted on the London Stock Exchange (Prais, 1976: 90).

Though the publicly quoted company was becoming a well-established part of the UK economy as the 20th century began, the managerially-dominated "Berle-Means" corporation did not move to the forefront until later. The complicating factor was family involvement. With many British public companies that joined the stock market, the entrepreneurs who founded the firms and their heirs retained a sizeable percentage of the shares and played a prominent role in managerial decision-making. A commitment to personal ways of management was therefore perpetuated (Chandler, 1990: 240).

In the years prior to 1914 family dominance was very much the prevalent pattern in the UK's public companies (Hannah, 1976: 24; see also Chandler, 1976: 32-40). Family control became less pervasive in the decades that followed but it is not precisely clear when matters had progressed sufficiently so it could be said that the Berle-Means corporation was dominant in the UK.[7] There is some evidence which suggests that the period prior to 1950 was pivotal. Contemporaries, for example, referred to "the widening divorce

between ownership and management (Changing Capital, 1937: 1508)."

Academic research carried out subsequently also suggests that a division of ownership and control may have been established in the UK by the middle of the 20th century. P. Sargant Florence, an economist who examined share ownership patterns in Britain's larger industrial and commercial companies as of 1936 and 1951, found a clear trend of increased share ownership dispersion (1961; 1972: 213-41; Payne, 1978: 211-13, 221-22). He concluded on the basis of his evidence that a "managerial evolution, if not revolution" was taking place and said that a trend towards a divorce between control and ownership "was clear for very large companies" (1961: 186-87). Analysis done by Leslie Hannah, a British business history expert, lends additional support to the idea that the foundations of US-style managerial capitalism were firmly established in the UK by the middle of the 20th century. He notes that, while family members had a *de facto* veto over any proposed bid for control in the decades immediately following World War I, by the 1950s the divorce of ownership and control had proceeded sufficiently to leave a wide range of quoted companies vulnerable to takeover offers (1974: 67-68; 1976: 130-31, 149-50).

It is not clear whether Florence and Hannah have correctly identified when a separation of ownership and control was well-established in the UK. Alfred Chandler, an American business historian who has written widely on both the United States and Britain, says that during the first half of the 20th century the nature of industrial capitalism was considerably different in the two countries (1976; 1980*a*; 1991: ch. 7). In larger American companies, professionally-trained, salaried executives made the key decisions and administered their firms through extensive impersonal networks. In Britain, in contrast, a commitment to personal ways of management prevailed since administrative hierarchies were primitive and families continued to play an influential role.

Chandler has suggested that US-style managerial capitalism probably became well-established in Britain during the 1970s (1976: 45-6, 49). By this time, only a small percentage of directors had family connections with important shareholders and UK companies were adopting the sort of complex managerial structures which had been common in the US for some time. Still, empirical work carried out by sociologist John Scott indicates the transition to a separation of ownership and control may not have been complete by the end of the 1970s. Scott examined both 1976 and 1988 ownership patterns in the UK's 200 largest industrial companies and 50 largest financial businesses (1984, ch. 4; 1985: 77-78; 1990; 1997: 83-84). According to his data, of the firms which were not state-owned, wholly-owned subsidiaries or mutual entities owned by depositors and policy holders (e.g. insurance companies and building societies), the ratio of companies having a shareholder owning more than 10% of the equity dropped from nearly one out of two in 1976 to just over one out of three in 1988 (1985: 77, derived from Table 15; 1990: 362, derived from Table I). Scott attributed this shift primarily to the decline of family control in UK companies (1990: 366-67; 1997: 89-90). The upshot is that while the key elements of US-style managerial capitalism may not have been entrenched by the middle of the 20th century in Britain, they were by the 1980s.

5. Law and the Separation of Ownership and Control in the UK: the First Half of the 20th Century

Again, according to the law "matters" story, a country is only likely to develop a vibrant stock market and a widely dispersed pattern of share ownership if its legal regime provides sufficient protection to minority shareholders to allow them to feel "comfortable". It would seem to follow that the UK should have been developing this sort of legal regime as the 20th century progressed. To recapitulate, the country should have had an honest and reliable judicial system. Also, it should have been putting laws in place that regulated shareholder voting and pre-emptive rights, imposed a duty of loyalty on directors, provided minority shareholders with legal mechanisms to counteract perceived

oppression, constrained insider dealing and compelled disclosure by publicly quoted companies.

In reality, the pattern in the UK was quite different. The legal system in fact did not do a great deal to improve the "comfort level" of outside investors. A helpful way to illustrate this point is to distinguish between events occurring prior to the middle of the 20th century from those occurring thereafter. This is because the regulation of companies began to change dramatically with the enactment of new legislation in the late 1940s.

5.1 "Laissez Faire" Britain

While it is open to debate whether a separation of ownership and control was well-established in the UK by the middle of the 20th century, by this point in time hundreds of companies had joined the stock market after carrying out successful public offerings of shares. This pattern would suggest that, assuming general market conditions were not unduly adverse,[8] there was a healthy demand for corporate equity among the investing public (Michie, 2000: 258). Indeed, a business historian has described the response to public offerings carried out by British industrial companies during the mid-1920s as follows:

"It was apparent from the reception accorded to these issues that the public had large resources and in addition a 'willingness to respond with avidity to any offer that possessed reasonable merit or attraction" (Thomas, 1978: 29).[9]

Since investors were happy enough to purchase shares distributed by UK companies, they apparently were content to take on the potentially vulnerable status of minority shareholder. One would infer from the "law matters" thesis that the legal system must have been providing outside shareholders with protection that made them "comfortable". In one respect, this was probably true. Investors are unlikely to feel confident in a country where judges are corrupt and

court procedures are cumbersome. The English judicial system far exceeded this sort of minimum standard.[10] The judges who heard commercial cases prided themselves on their incorruptibility, impartiality, and decisiveness. Indeed, they established for themselves an international reputation for professionalism, independence and continuity (Scrutton, 1921; Cheffins, 1997: 443).

While the judicial system had various commendable features, in most respects Britain did not qualify as a "protective" jurisdiction for outside investors. Instead, prior to the middle of the century, neither UK companies legislation nor relevant common law principles afforded much explicit protection to minority shareholders (Gower, 1954: 52). Indeed, a financial journalist writing for the *Economist* in 1929 said

"Certain safeguards are laid down for the protection of minorities…but for the most part the underlying assumption of the law is that the ultimate power lies with the majority of shareholders…" (Shareholders, 1929: 691).

This sort of "hands-off" approach in fact was prevalent generally in the company law area. A critic observed in a book published in 1933 that "in England the Victorian ideal of *laissez-faire* still permeates the attitude of a great many people toward Company reform" (Samuel, 1933: 9).

A review of various laws that might have helped to make outside investors feel "comfortable" illustrates that, from a legal perspective, the UK was not a "protective" jurisdiction for minority shareholders during the first half of the 20th century. For instance, the issuance of shares with unequal voting rights was not regulated (Mears, 1957: 258-61) and the same sort of "hands-off" approach prevailed with pre-emptive rights (Gower, 1954: 346). With respect to a duty of loyalty, English courts did oblige directors to act in a company's best interests and to avoid conflicts of interest.[11] Nevertheless, judicial caution served to diminish the significance of these duties. When a

case involving directors' duties came before the courts, the judiciary was generally reluctant to meddle (Samuel, 1933: 127-43; Cheffins, 1997: 312-16).

English judges would step forward in directors' duties cases where fraudulent behaviour or dishonesty was involved (Gower, 1956: 1383; Cheffins, 1997: 316-18). Still, they generally preferred not to subject corporate decision-making to rigorous scrutiny. The following quotes from appellate judgements from the beginning of the 20th century illustrate the point. Lord MacNaughten said in the *National Bank of Wales* case

"I do not think it desirable for any tribunal to do that which Parliament has abstained from doing – that is, to formulate precise rules for the guidance or embarrassment of business men in the conduct of business affairs".[12]

Lord Davey echoed similar sentiments in *Burland v. Earle*:

"It is an elementary principle of the law relating to joint stock companies that the Court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so."[13]

Steps taken by those associated with companies also served to mute the impact of directors' duties in the UK. The legal principles governing transactions where directors had a conflicting personal interest illustrates the point. Statutory regulation in the area was negligible, with the primary exception being a provision enacted in 1929 that required a director who had a conflict to disclose this at a board meeting (Companies Act 1929: s. 149). On the other hand, the common law was quite strict, since a breach of duty could arise even if an impugned contract was reasonable and fair.[14] It was standard practice, however, for UK companies to relax the law by adopting exculpatory clauses in the corporate constitution (Samuel, 1933: 160; Davies, 1997*a*: 611-12). Moreover, it was always possible for

shareholders to "whitewash" a breach of duty by ratifying a conflict of interest transaction, and the directors who were potentially at risk were entitled to vote their shares on any such resolution.[15]

Giving minority shareholders legal mechanisms to contest oppression by those controlling a company should, according to the "law matters" thesis, serve to enhance the confidence of outside investors. The law in the UK was not very forthcoming on this score, however, prior to the middle of the 20th century. Derivative actions, for instance, were relatively uncommon and undeveloped (Gower, 1956: 1385). This, in large part, was because the judiciary was reluctant to give minority shareholders standing to sue on a company's behalf (Samuel, 1933: 149-50; Cheffins, 1997: 102).[16] With respect to shareholders' "appraisal" rights, while these were widely available as a remedial device in the US, they played a very minor role in the UK (MacIntosh, 1989: 572-75). Moreover, during the first half of the 20th century, UK companies legislation did not contain a provision authorising a minority shareholder complaining of oppression or unfair prejudice to apply to court for relief.[17] The judiciary, moreover, did not fill this gap. Instead, judges failed to develop "principles which would afford adequate protection of the minority against oppression by the majority (Gower, 1954: 52)."

Consistent with the *laissez-faire* pattern that prevailed in the company law area in the UK in the first half of the 20th century, insider dealing was unregulated. The matter was not dealt with by legislation and, as a result of a ruling made in a 1902 case,[18] it was "generally assumed that directors (had), legally, *carte blanche* to put to personal advantage their inside information in dealing in their company's securities" (Gower, 1954: 139). Hence, as one contemporary observed "the sanction against (insider dealing) is rather one of etiquette than one of positive law" (Samuel, 1933: 168). Anecdotal evidence in fact suggests that most thought the practice was quite acceptable (Moran, 1991: 80; Kynaston, 1999: 298).

The *laissez faire* trend was also prevalent with respect to disclosure. At first glance this is surprising, since one of the UK's leading company law scholars wrote in the mid-1950s that "(o)n the basis that 'forewarned is forearmed' the fundamental principle underlying the Companies Acts has been that of disclosure (Gower, 1954: 431)." In fact, though, prior to the middle of the 20th century the regulation of business disclosure was very relaxed by contemporary standards (Kennedy, 1994: 126).

One area where there was regulation was prospectuses. These were documents which companies distributed when they went public for the first time or subsequently carried out public share offerings. Parliament enacted legislation in 1890 which stipulated that plaintiffs could recover damages if they had suffered loss by reason of an untrue statement in a prospectus and those responsible could not prove they had reasonable grounds to believe the statement was true.[19] Also, from 1900 onwards, UK companies legislation specified various matters that those preparing a prospectus had to disclose.[20]

While prospectus requirements meant that companies were compelled by statute to carry out disclosure when they issued shares to the public, UK companies legislation did little to oblige companies to divulge information on any sort of ongoing basis. This was not because the topic was thought to be unimportant. Contemporaries recognised that shareholders should receive adequate periodic information with respect to companies (Samuel, 1933: 231). Nevertheless, the obligations which UK companies legislation imposed were rudimentary (Hannah, 1974: 69-70).

The process of regulation, such as it was, began in 1908. From that point onwards, companies were under a legal duty to file publicly an annual balance sheet (i.e. a statement of a company's assets and liabilities at the end of each financial year).[21] This, however, was an historically-oriented document that did not, as a general rule, purport to show the trend of profits or the net worth of the undertaking at any particular date (Cohen Report, 1945: para. 98; Kennedy, 1994: 126).

With the enactment of the Companies Act 1929, companies became, for the first time, statutorily obliged to provide data on current earnings. This statute stipulated that a company's directors had to present, at the annual meeting of the shareholders, the firm's profit and loss account for the preceding twelve months (s. 123). The directors, however, were free to provide global figures rather than account separately for trading operations, income derived from investments and profits of a non-recurring character (e.g. the sale of a capital asset) (Samuel, 1933: 268-69). Moreover, companies were not obliged to circulate or file publicly the profit and loss account documentation they prepared (Samuel, 1933: 267; Gower, 1954: 438). Also, assuming a company had carried out appropriate disclosure when it filed its balance sheet and presented its profit and loss account to shareholders, it was not under any statutory onus to disclose key developments on an ongoing basis (Samuel, 1933: 307).

5.2 Factors Reducing the Vulnerability of Investors

5.2.1 Financial Intermediaries

While neither UK companies legislation nor relevant common law principles afforded much explicit protection to minority shareholders during the first half of the 20th century, the vulnerability of the country's investors should not be overstated. The involvement of financial professionals when companies sold shares to the public was one factor which improved the "comfort level" for investors in Britain. To understand why this was the case, some background is required. Firms which put together public offerings of shares on behalf of their clients normally want to protect their good name since being known as reliable will give them an edge over the competition in securing future clients. To build and preserve a sound reputation, they will seek to ensure that with a public offering the shares continue to offer good value when trading begins in what is commonly referred to as the "aftermarket". They can endeavour to do this by scrutinising closely a company's prospects prior to bringing it to the market and

by orchestrating changes designed to create a favourable impression with investors (Cheffins, 1997: 166-67; Cheffins, 1999b: 661-63; Black, 1999: 13).

Prior to World War I, it is doubtful whether the reputational concerns of financial intermediaries provided meaningful "quality control" for those contemplating investing in UK companies. First-class merchant banks in London's financial district ("the City") should have been the firms most interested in protecting their good name. These organisations were not particularly keen, however, to become involved with the public offerings that domestic companies were beginning to carry out. They were focusing instead on the issuance of securities by British and overseas governments and by railroads and public utilities (Collins, 1991: 43, 53; Kynaston, 1995: 456).

Since domestic industrial and commercial companies that were carrying out public offerings did not rely heavily on top-tier merchant banks, they generally turned to financial advisers specialising as "company promoters". The individuals involved tended to be flamboyant and makeshift rather being diligent, honest and careful (Thomas, 1978: 23; Knayston, 1995: 183, 457-58). Investors, in turn, suffered. Armstrong (1990: 130-31) has delivered this harsh verdict:

"Because of the unscrupulous activities of the least honourable promoters many of 'their' firms failed in (downswings of economic activity) or at least failed to live up to expectations. This tarnished individual firms' reputations and permeated whole groups of businesses….Indeed, at times, there were (*sic*) a general distrust of domestic industrial shares as a whole, the group being perceived as high risk."

While financial intermediaries apparently did not offer much protection to outside investors prior to World War I, the situation improved considerably thereafter (Thomas, 1973: 251-53; Thomas, 1978: 48-50; Collins, 1991: 84-85; Michie, 2000: 260-61, 268-69). Admittedly, there were still examples of unscrupulous promoters who

were more interested in salesmanship than quality control (Samuel, 1933: 17-20; Thomas, 1978: 40, 49-50, Michie 2000: 261-64). At the same time, though, financial intermediaries who had reason to take a prudent line when organising public offerings were playing an increasingly pivotal role. Indeed, matters had progressed by the middle of the 20th century to the point where, such advisers, being concerned about their reputations, would subject new issues to "the most stringent scrutiny" to ensure that these were "sound financially as well as legally" (Gower, 1956: 1382).

Various types of financial intermediaries conducted themselves in a way that enhanced the legitimacy of the new issue market. Stockbroking concerns composed one such category. Such firms generally specialised in the buying and selling of shares already on the market. Still powerful stockbrokers were well-situated to handle share offerings directly because they were familiar with the domestic economy, had strong links with the business community and had the contacts required to place shares with wealthy clients (Thomas, 1973: 253; Michie, 2000: 229-30, 260-61, 268).

Finance houses constituted another group of reputable intermediaries. They were often organised as an investment trust (a publicly traded entity established to manage a portfolio of assets), had good connections and reasonable capital resources (Thomas, 1973: 251-52; Kynaston, 1999: 136-37; Michie 2000: 95). A contemporary said of such institutions:

"they are permanently engaged in financial operations, and…having a reputation to loose (*sic*), they give the public some measure of assurance of the worth of their issues" (quoted in Thomas, 1978: 49).

London's leading merchant banks (e.g. Barings, Rothschilds and Lazards) constituted an additional type of intermediary that enhanced the credibility of the new issue market. These powerful institutions became increasingly willing to act as advisers for domestic companies after World War I, in part because of a significant reduction in the

volume of foreign business (Thomas, 1978: 48; Collins, 1991: 84; Michie, 2000: 268-69).

5.2.2 The Stock Exchange

At the same time that financial intermediaries were beginning to provide meaningful quality control in the UK's equity markets, London's Stock Exchange was stepping forward as an important player.[22] It did so as a private association without direct links with the Government; its rule book operated purely through the laws of contract and agency (Fishman, 1993: 23-24). Prior to World War I, the Stock Exchange had few regulations governing domestic companies with shares listed for trading, presumably because the domestic equity market was a relatively unimportant one at the time (Armstrong, 1990: 115). Matters changed, however, thereafter.

The primary contribution the Stock Exchange made to improve investor protection prior to the middle of the 20th century was to strengthen the requirements imposed on companies seeking to carry out public offerings of shares. Indeed, according to a report issued in 1945 by a committee set up by the UK government to study the reform of company law, officials at the Exchange "exercised a beneficial influence in the matter of issues" (Cohen Report, 1945: para. 24). The scope existed for regulation to occur because the Stock Exchange's Share and Loan Department had to give the go-ahead before dealing in shares issued by a company could commence (Cohen Report, 1945: paras. 23-24).

Before granting permission for dealing to begin in newly issued shares, the Share and Loan Department would make "searching" enquiries concerning the proposed share offering and the personnel connected with the company (Cohen Report, 1945: para. 23; see also Grant, 1979: 165). The relevant officials would also ensure that there had been compliance with Stock Exchange rules requiring a company to include specified provisions in its corporate constitution (Code Holland and Werry, 1932: 102-3). Finally, the company making the

public offering was obliged by the Stock Exchange to divulge specified information concerning its business operation and the offering itself (Code Holland and Werry, 1932: 93-95). The information companies were compelled to disclose was similar to that which had to be inserted in a prospectus under UK companies legislation but was in many respects more extensive. Indeed, there was a continuous process of cross-fertilisation between the Stock Exchange's requirements and the statutory rules, with the former generally in advance of the latter (Gower, 1954: 293).

When the Stock Exchange became more vigilant in the supervision of public share offerings, it did not act entirely on its own initiative. A scandal involving improperly issued shares that came to light in 1929 led to debate about possible government intervention in securities markets (Michie, 2000: 262-63, 281). The Stock Exchange responded to this potential challenge by exhibiting a greater willingness to police the market for domestic corporate securities (Michie, 2000: 264, 281-82). Hence, while during the 1920s the Stock Exchange was generally willing to quote any securities that offered the prospect of generating good business for those entitled to deal on the Exchange, in the 1930s companies lacking a proven track record could find it difficult to get their shares listed for trading (Michie, 2000:268, 272, 282).

The Stock Exchange's status as a regulator received a boost as a result of circumstance: leading figures in the UK financial community were generally from "establishment" backgrounds and worked in close proximity in "the City" (Kynaston, 1999: 326-47). As an American expert on UK financial services regulation has said:

"Stock Exchange self-regulation worked because it operated in a close community with a higher degree of homogeneity, social exclusivity, common backgrounds, and, most importantly, shared values. Problems were handled internally. Private regulation served to boost the public's belief in the Exchange's integrity" (Fishman, 1993: 26)."

Also helpful to the Stock Exchange was a general acceptance in the UK of the legitimacy of self-regulation. In Britain, people often established, of their own accord, industrial, professional and social organisations to oversee and regulate matters of common interest. Consequently, there was a well-established tradition of self-regulation (Cheffins, 1997: 365).

5.3 Putting the UK's "Laissez-Faire" Experience into Context

One observer, writing in 1931 on the finance of British industry, said

"In no other country are there organisations which surpass in efficiency the experience of the London Stock Exchange, the London issuing houses, investment houses and under-writing agencies, and in no other country is there a more varied and enterprising band of company promoters than is to be found within the boundaries of the City of London" (quoted in Michie, 1992: 116).

Two decades later, a leading UK company law academic praised the "initial screening" which firms organising public offerings and stock exchange officials carried out and added that "it is largely to extra-legal techniques that investors owe their present relative immunity from sharp practice" (Gower, 1954: 335, 336). The expression of such sentiments by contemporaries serves to confirm the point being made here: there can be a healthy demand for small holdings in public companies without a highly protective legal regime if alternative institutional safeguards are in place.

The British experience in the first half of the 20th century was not an isolated one. Instead, one can draw parallels with developments in the US. In an American context, the Securities Act of 1933 (15 USCA §77), the Securities and Exchange Act of 1934 (15 USCA §78) and supporting laws have been credited with helping to create an environment where the dispersed shareholder is happy to invest (Coffee, 1999: 683-89, 699-704; Black, 1999: 5-6). It appears, however, that the widely held public company was in fact well-

established in America before the federal government reformed the country's securities markets (Roe, 2000: 52-53). Berle and Means (1932), after all, set out their separation of ownership and control thesis prior to the enactment of the 1933 and 1934Acts. The historical evidence suggests that to the extent that organised efforts were made to create an environment where investors would have sufficient confidence to buy shares in publicly quoted companies, privately owned stock exchanges were responsible (Mahoney, 1997: 1465-70). Indeed, the 1933 and 1934 Acts may have done little more than codify best practice as exemplified by the rules of the New York Stock Exchange (Roe, 2000: 53).

6. Law and the Separation of Ownership and Control in the UK: the Second Half of the 20th Century

While the British experience in the first half of the 20th century serves to cast doubt on the "law matters" thesis, it is unwise to draw firm conclusions on the basis of what has been said thus far. As we have seen, it is open to debate whether the Berle-Meanscorporation was in fact well-established in the UK by the middle of the 20th century. It may well be that the widely-held, professionally managed public company did not become dominant until a few decades later. If this in fact is accurate, British history may still fall into line with the "law matters" thesis. This is because the legal regime governing companies and their shareholders became considerably more intricate and complex from the late 1940s onwards.[23] Indeed, by the 1980s the Victorian ideal of *laissez-faire* was merely a dim memory and critics were bemoaning the fact that the UK's statutory regime imposed needless regulatory requirements and was far more complex than necessary (Sealy, 1984: 5-6, 10-14). This section provides an overview of the relevant trends and indicates that, despite the move towards increased regulation, developments in the UK do not provide significant support for the "law matters" thesis.

6.1 Areas of the Law Where the Status Quo Largely Prevailed

While from the 1940s onwards the general trend with the law governing UK companies was in the direction of increased regulation, with various issues that might have been expected to affect the comfort level of shareholders in public companies, the law changed little. This was the case, for instance, with shares with unequal voting rights, since UK companies legislation continued to say nothing on the matter (Cheffins, 1997: 177). Appraisal rights and derivative litigation were two other areas of the law relevant to minority shareholders where the status quo largely prevailed. Throughout the latter half of the 20th century, shareholders only had under highly exceptional circumstances the dissent and buy-out rights associated with appraisal (MacIntosh, 1989: 572-73; Cheffins, 1992: 92). With derivative litigation, the courts rejected attempts to loosen the restrictive procedural rules established in the 19th century. Indeed, they threw the process into reverse by placing new barriers in the way of a shareholder acting without majority support (Davies, 1997a: 676).[24]

Subject to one noteworthy qualification, directors' duties constituted one further area of the law that was potentially significant for minority shareholders where the underlying principles remained largely fixed. Throughout the latter half of the 20th century, various proposals were made to codify directors' duties in UK companies legislation. Each effort failed, which meant that the area continued to be governed by the common law (Law Commissions, 1998: paras. 13.7-13.20). Still, extensive change did take place with respect to transactions where directors had a conflicting personal interest. The Companies Act 1948 stipulated that companies could not make loans to directors and subsequent legislative amendments extended considerably the range of transactions that were regulated (s. 190; Law Commissions, 1998: Appendix C).

In addition to those instances where the law affecting minority shareholders did not change a great deal, there were various situations

where reform did occur but the status quo still largely prevailed. This was because the changes that took place did not have a major practical impact, at least for those who invested in public companies. The experience with pre-emptive rights is illustrative. In 1980, the UK Parliament enacted a provision requiring companies issuing new shares to make the equity available on a pro-rata basis to existing shareholders in accordance with the percentage of shares already owned (Companies Act, 1980, ss. 17-18; see now Companies Act 1985, s. 89). It became standard practice, however, for companies in the UK to take advantage of prescribed procedures to opt out of this requirement. This was not because pre-emptive rights were unpopular. Indeed, shareholders in public companies frequently preferred that newly issued equity be offered for sale on this basis. The procedure that publicly quoted companies generally adopted was to comply with relevant provisions in the Stock Exchange listing rules and follow guidelines developed by investment committees formed by institutional shareholders (Cheffins, 1997: 494-95).

The creation of a procedure by which an aggrieved shareholder could seek judicial relief against alleged mistreatment constituted a second instance where the UK Parliament changed the law but the practical impact was minimal, at least in public companies. The Companies Act 1948 (s. 210) expanded in a very tentative fashion the jurisdiction which courts had to provide relief to disgruntled shareholders (Gower, 1969: 600-4). Parliament followed up in 1980 by authorising the judiciary to grant a remedy to a shareholder who had been unfairly prejudiced by the actions of the company (Companies Act 1980, s. 75; see Davies, 1997*a*: 740-42). The provision, which is currently set out in s. 459 of the Companies Act 1985, applies to all companies, including those with publicly traded shares. Nevertheless, by virtue of judicial interpretation, the likelihood of a successful petition is much greater in a closely held company (Cheffins, 1997: 464). Correspondingly, while applications to court occur often, proceedings are extremely rare with publicly quoted companies (Law Commission, 1996: 236).

Insider dealing is one further area where significant legal reform occurred but the practical effect seemed to be negligible. Parliament took its first step towards regulation in 1948 by obliging companies to prepare and have available for inspection information regarding share transactions of directors (Companies Act 1948, s. 195; see now Companies Act 1985, ss. 324, 328). In 1967, the disclosure obligations were made more extensive and were extended to cover shareholders owning 10 per cent or more of a company's shares (Companies Act 1967, ss. 27-29, 31, 33-34). Contemporary observers thought that the new provisions might curb some of the worst abuses from clandestine dealings by insiders but conceded that the UK had not gone nearly as far as the US in the insider dealing area (Gower, 1969: 391).

Parliament took its next step in the regulation of insider dealing in 1980 by making it a criminal offence for a director or other insider to trade while in possession of confidential, price sensitive information (Companies Act 1980, ss. 68-73).[25] There certainly was some awareness of the offence. For instance, institutional investors in the UK were reluctant to be made insiders because they feared a loss of liquidity (Cadbury Report, 1992: para. 6.14; Black and Coffee, 1994: 2025). Still, it is doubtful whether the statutory prohibition had a major impact. This was because of minimal enforcement activity; there were only 24 convictions in the two decades following the creation of the insider dealing offence (Foley, 2000).[26]

The low number of insider dealing convictions in the UK did not mean the practice had been eradicated. Indeed, by the end of the 1990s, London's Stock Exchange was mounting major investigations into more than 100 suspect trades a year and was referring 30 to 40 cases a year for possible prosecution (Foley, 2000). The primary reason for the low number of convictions in fact was that prosecutors were not keen to proceed, since meeting the criminal standard of proof "beyond a reasonable doubt" was difficult. Indeed, the thinking was that short of a signed confession, it was almost impossible to make charges stick (Ashworth and Jones, 2000).

6.2 Statutory Disclosure

While there were instances where reform occurring during the second half of the 20th century did not have major practical consequences for outside investors in public companies, other changes may well have done so. Statutory rules governing disclosure of information stand out as a possible example. The Companies Act 1948 expanded considerably regulation of this area. It obliged companies to file enlarged, more demanding prospectuses when carrying out public offerings of shares (s. 38, sch. 4; Kynaston 1991: 195-96). With respect to disclosure by companies on a periodic basis, the 1948 Act stipulated that companies had to file publicly their annual profit and loss accounts as well as their balance sheets (ss. 126(1), 127, 159). It also set out for the first time detailed provisions regulating the form and content of both the balance sheet and the profit and loss account (schedule 8; Buckley, 1949: 965).[27] Another innovation was to require company accounts to be prepared so that they gave a "true and fair view" of a company's financial position (Companies Act 1948, s. 149(1); Buckley, 1949: 345).

Further significant changes were made subsequently to the statutory regime governing disclosure. In 1981, Parliament implemented a European Union (EU) directive dealing with accounting issues (Companies Act 1981, ss. 1-21).[28] A major by-product of this process was that companies were required for the first time to prepare their accounts in accordance with standardised formats (Edwards, 1989: 217-20). Action taken by the EU also prompted Parliament to revamp the legislation governing other aspects of disclosure. For instance, the statutory measures dealing with prospectuses and similar documentation were revised considerably (Financial Services Act 1986, Part IV).[29] Moreover, regulatory measures were enacted which imposed various continuous disclosure obligations on companies with publicly quoted shares.[30]

While some observers have speculated that enhanced statutory disclosure made shares seem less risky to UK investors (Kynaston, 1999: 213), it is not entirely clear whether mandatory disclosure requirements in fact lead companies to divulge information that is useful or important. For example, some academics studying the securities laws which the US Congress enacted in 1933 and 1934 have argued that interested parties had access to a wide range of reliable data prior to intervention by Congress (Cheffins, 1997: 164-65; Mahoney, 1997: 1466-70). Still, the evolution of the takeover bid in the UK illustrates that increased regulation of disclosure perhaps did have a significant impact on Britain's publicly traded companies.

Until the 1950s it was rare for a "raider" to seek to gain control of a company by offering to buy the equity of existing shareholders (Hannah, 1974: 67; Johnston, 1980: 8-10). Activity of this sort was then common thereafter (Hannah, 1974: 65-67; Hadden, 1977: 374-75). Increased statutory disclosure may have contributed to this trend. According to Hannah (1974: 69-71; 1976*b*: 130-31), potential takeover bidders did not have sufficient data available to carry out necessary screening activity until the middle of the 20th century. Matters changed, though, when the Companies Act 1948 required UK companies to disclose more about their assets, profits and so on. Legislative reform thus served to increase the vulnerability of quoted companies to takeover bids (Hannah, 1974: 75; Hannah, 1976*b*: 149-50). Takeovers are widely interpreted as a critical governance mechanism in the Berle-Means corporation since the threat of a bid gives incumbent management an incentive to focus on shareholder value (Easterbrook and Fischel, 1991: 171-73; Rock, 1996: 374-75; Shleifer and Vishny, 1997: 756). If Hannah's account is correct, it illustrates that the law can influence the emergence of features normally associated with the Berle-Means corporation.

The historical evidence relating to takeovers can also be relied upon to cast doubt, however, on the significance of law. Prior to the late 1960s, the main controls over takeover bids were the UK's laws governing anti-competitive behaviour (Hadden, 1977: 369). In this

unregulated environment, a frequent complaint was that terms offered to shareholders of a target company were unequal (Hadden, 1977: 375). For instance, objections were raised against "partial" bids, where inequality of treatment was inherent since the offer to purchase outstanding equity was not extended to all shareholders (Hadden, 1977: 375; Johnston, 1980: 20-21). Concerns were also expressed about insufficient disclosure and misuse of inside information (Hadden, 1977: 375-76; Johnston, 1980: 158-59; Michie, 2000: 376-77, 427-28).

The response to the growing discontent concerning takeover bids was "self-regulatory" in nature (Hadden, 1977: 377; Johnston, 1980: 5-7, 137-38). In the late 1960s, leading financial institutions in "the City" established the Takeover Panel to supervise the conduct of takeover offers involving UK public companies. The Panel developed a series of rules concerning bids and these addressed unequal treatment, disclosure and misuse of confidential information (Hadden, 1977: 378-87; Johnston, 1980: 37-40, 55-56). Even though the Panel had no statutory powers, its regulatory efforts were successful in large measure (Hadden, 1977: 387; Johnston, 1980: 123-24; Cheffins, 1997: 380-81). Thus, to the extent that UK investors had concerns about mistreatment by bidders or insiders in the takeover context, self-regulation, not law, provided the response.

A more general point also needs to be made about disclosure and self-regulation. This is that the Stock Exchange, acting in a self-regulatory capacity, was making its disclosure rules more rigorous at the same time that statutory intervention was increasing. For instance, while the UK Parliament began to regulate continuous disclosure in the 1980s, the Stock Exchange had stepped forward on this issue much earlier. By the 1950s, the Exchange's listing rules obliged a publicly quoted company to reveal key changes affecting the business, including any information necessary to avoid the establishment of a false market in the company's shares (Gower, 1954: 437). The Stock Exchange took fulfilment of such continuous disclosure duties seriously and would, if necessary, suspend dealing in the shares of companies that were

breaching their obligations (Gower, 1954: 437-38). Indeed, the control exercised by the Stock Exchange went "some way towards rivalling the (US Securities and Exchange Commission's) supervision of corporate activities (Gower, 1954: 307)."[31]

Disclosure innovations introduced subsequently by London's Stock Exchange included requiring companies listed on the Exchange to send an interim financial report to shareholders and to make a preliminary announcement prior to the formal release of financial results (Council of the Stock Exchange, 1973, appendix 34, sch. VII (Part C); sch. VIII (Part A, para. 8)). The upshot was that publicly quoted companies were obliged to provide more information than was required by UK companies legislation, despite the growth in statutory regulation (Boyle, 1986: paras. 10.16, 23.21). Since this was the pattern, even if disclosure obligations helped to foster the emergence of the Berle-Means corporation in the UK, it is unclear whether legislative intervention deserves the credit.

6.3 Transformation of the Stock Exchange

As with disclosure, the fact that London's Stock Exchange was brought firmly within a formalised system of regulation in the years after World War II was a legally-related change that had potentially significant implications for investors in UK public companies. Since the Stock Exchange was, prior to the middle of the 20th century, a purely private association with a rule book which operated through the laws of contract and agency, it constituted "the classic example of intrinsic self-regulation (Page 1986: 145)." The situation changed significantly in the decades that followed since London's Stock Exchange was transformed into a regulator with strong governmental links.

The change in the Stock Exchange's status is important from an analytical perspective because, from the middle of the 20th century onwards, it was establishing a wide range of new requirements potentially relevant to outside investors in public companies. As we

have just seen, it introduced increasingly rigorous disclosure requirements. In addition, the Stock Exchange stipulated from the 1960s onwards that companies should signal clearly when shares were non-voting and should observe pre-emptive rights when issuing equity (Gower, 1969: 350, 369). Moreover, by the late 1970s, the Stock Exchange had amended its listing rules to require companies to obtain shareholder approval before carrying out major acquisitions and disposals of assets (1979, ch. 4, para. 17; sch. VIII, Part A, para. 5(a)). The Stock Exchange had also developed safeguards to circumscribe share dealings by insiders and to regulate transactions between a company and a director or a substantial shareholder (1979: ch. 2, para. 20, Appendix entitled "Model Code for Securities Transactions by Directors of Listed Companies"; ch. 4, para. 8).

The Stock Exchange's transition towards formal regulatory status began during World War II. As a result of the war, the UK government took over the management and planning of the British economy. As part of this process, a working relationship developed between the government and the Stock Exchange, primarily through the Treasury, a government department, and the Bank of England, the UK's central bank (Michie, 2000: 291, 324). Essentially, during the War years, the Stock Exchange exerted formal control over UK securities markets but it was fully responsive to the priorities of the government when it exercised its authority (Michie, 2000: 291-94).

After the end of World War II, the Stock Exchange regained its independence but various links with the government remained in place. With public offerings of shares, the Bank of England and the Treasury both exercised some formal supervisory powers during the 1950s and 1960s (Gower, 1969: 289-90; Cheffins, 1997: 367). On the disclosure front, the Companies Act 1948 created a formal overlap between the statutory regime and Stock Exchange rules dealing with the same topic (ss. 39, 51). More generally, Stock Exchange officials engaged in an ongoing process of informal consultation with the Bank of England and were aware that a failure to regulate UK securities markets effectively in accordance with government priorities might

lead to direct statutory control (Michie, 2000: 363-68, 416, 423-26, 481, 485-87, 541-42).

While links between London's Stock Exchange and government institutions had developed prior to the mid-1980s, the Exchange still constituted a "prime example of self-regulation" since it was a voluntary association acting without formal legislative authority (Johnston, 1980: 6). At this point, though, things changed. Parliament undertook a major restructuring of financial services regulation in the UK, culminating in the enactment of the Financial Services Act 1986.[32] The new regime was supposed to function as "self-regulation within a statutory framework" and a major by-product of the reform effort was that the Stock Exchange was brought firmly within a statutorily-based regulatory regime (Cheffins, 1997: 365, 367-68). For instance, the Stock Exchange was designated under the Financial Services Act 1986 as the competent authority responsible for setting requirements for companies seeking to have their shares listed for trading on a stock market (s. 142(6)).[33] In addition, the Stock Exchange's own listing rules were vested with the status of subordinate legislation (ss. 143-44).

The timing of the changes to the UK's system of financial regulation is important for understanding the law's contribution to the rise of the Berle-Means corporation in the UK. While it is uncertain whether a separation of ownership and control was well-established by the middle of the 20th century, it does seem clear that this had taken place before the 1980s drew to a close. As a result, the shift occurred prior to the decisive change in the Stock Exchange's status as a regulator. Hence, even if allowances are made for changes affecting the Stock Exchange in the latter half of the 20th century, the fact remains that law did not have a pivotal influence on the perceptions of outside investors or the evolution of corporate governance patterns in the UK.

7. Conclusion

Since "creating strong public securities markets is hard" (Black, 1999: 1), a thesis which is gaining growing acceptance is that the legal system has a potentially decisive contribution to make. The law's role, according to this thesis, is to provide investors with sufficient protection against insider opportunism to allow them to be confident about owning a tiny stake in a publicly quoted company. The experience in the UK casts doubt on such reasoning. Unlike other major industrial countries, Britain and the US have an "arms-length/outsider" system of ownership and control. It is not precisely clear when Britain joined the club. According to one version of events, a separation of ownership and control becamewell-established in the UK by the middle of the 20th century. If this in fact did happen, then the law deserves little of the credit. The English judiciary admittedly had a reputation for professionalism, independence and impartiality, which may have served to boost investor confidence in some measure. Otherwise, though, the law offered minority shareholders little protection against opportunism by insiders. Instead, *laissez-faire* was the predominant trend.

According to a different version of events, the Berle-Means corporation did not become dominant in the UK until the 1970s or the 1980s. If matters did work out this way, then the implications for "law matters" thesis are not as straightforward as they are if a separation of ownership and control was well-established by mid-century. This is because the law governing companies became considerably more intricate and complex from the late 1940s onwards.

At first glance, it does seem that developments in the UK correlate with the "law matters" thesis. The *laissez-faire* tradition which had prevailed during the first half of the 20th century was displaced in ensuing decades. If the Berle-Means corporation did in fact became dominant during this period, an inference one could draw is that the evolution of a suitable legal environment contributed to the process.

Upon closer inspection, though, it is doubtful whether the British experience in the latter half of the 20th century lends support to the "law matters" thesis. Again, the assumption that underlies this thesis is that a country is only likely to develop a widely dispersed pattern of share ownership if its legal system regulates companies in such a way that outside investors feel "comfortable" about buying shares. This implies that the UK should, in the latter half of the 20th century, have developed a legal framework that left corporate "insiders" relatively little scope to engage in cheating and other opportunistic conduct. The extent to which Britain in fact did so, however, is open to question.

Admittedly, important changes were made to the laws regulating corporate disclosure after the middle of the 20th century. On the other hand, with respect to various other issues that might be expected to matter to minority shareholders (e.g. the status of non-voting equity, directors' duties, appraisal rights and derivative litigation), few major alterations were made. With some other topics that could have influenced the perceptions of those contemplating buying shares in publicly quoted companies, reform did occur but it is doubtful whether the practical impact was significant. Examples include pre-emptive rights, applications to court by unfairly prejudiced shareholders and insider dealing. The upshot is that, during the latter half of the 20th century, lawmakers in the UK did not do a great deal to provide a legal regime that would have made those buying shares in publicly quoted companies feel "comfortable". Moreover, while financial services reform occurring in the mid-1980s presumably had significant implications for UK investors, these changes took place after a separation of ownership and control was seemingly well-established in the UK. It follows that even if the Berle-Means corporation only became dominant in Britain after the middle of the 20th century, the "law matters" thesis does not account satisfactorily for this trend.

While events occurring in the UK do not provide support for the "law matters" thesis of corporate governance, it is prudent to exercise caution before reading too much into this. There is anecdotalevidence

which suggests that in countries with insider/control-oriented systems of ownership and control, market forces are having a destabilising effect and are causing some form of convergence along American corporate governance lines. One implication of the "law matters" thesis is that the extent to which a country's legal environment is hospitable to dispersed ownership could significantly influence the transition process. An inference one might be tempted to draw from the British experience is that the legal factor will not be important. After all, a separation of ownership and control was established in the UK even though the law did not do a great deal to foster a sense of confidence on the part of investors contemplating buying shares in publicly quoted companies.

Despite what happened in the UK, one must exercise caution before concluding that the law will be irrelevant to any future transition towards American-style corporate governance. The reason is that countries which do not share the same institutions and traditions as Britain may not be properly situated to develop along the same lines. In the UK, while the law probably did not do a great deal to make investors feel "comfortable", two extralegal factors did seem to do so.[34] One was the work done by financial professionals who organised public offerings of shares on behalf of UK companies. The firms that acted as intermediaries were motivated by reputational concerns to carry out quality control that benefited investors.

The other was intervention by London's Stock Exchange, which, as a private body, functioned without direct support from government throughout much of the 20th century. By scrutinising public offerings of shares, the Stock Exchange apparently helped to bolster investor confidence in the opening half of the 20th century. This pattern continued as the century progressed. Throughout the 1950s, 1960s and 1970s, the Stock Exchange amended its listing rules to deal with various matters of potential concern to outside investors, such as pre-emptive rights, self-dealing by insiders, insider trading and disclosure. At the same time, the Exchange's reputation for probity was growing

and compliance with its rules was substantial (Fishman, 1993: 24-26; Michie, 2000: 567).

Drawing upon the British experience, it is possible to infer that a country need not engage in wholesale regulatory reform to provide a suitable platform for convergence along American corporate governance lines. Instead, extralegal institutions can allow investors to become sufficiently "comfortable" to acquire tiny stakes in the country's publicly quoted companies.[35] Any such inference must, however, be drawn with considerable care. This is because the UK's financial and social environment may have been uniquely hospitable to the development of a suitable extralegal institutional structure. An important consideration was that "the City" was functioning as a leading financial centre as the 20th century began. This meant that when the country's companies began to move towards the stock market, a financial network was already in place that had a well-established tradition of mobilising funds for productive use. The presence of homogeneity, social exclusivity and shared values within "the City" was also noteworthy. In this milieu, problems that arose could be handled internally rather than by recourse to the courts or other external agencies.[36] Finally, there was a well-established tradition of self-regulation in the UK, which meant that the approach the Stock Exchange took towards supervision of capital markets was not in any sense an exceptional outcast.

Professor John Coffee, one of the leading advocates of the "law matters" thesis, has acknowledged that forces that encourage the development of trust and cooperation may transcend purely legal forces. He suggests, though, that strong legal protections should be an excellent proxy for these extralegal forces (1999*a*: 696). This may provide a lesson for policymakers in countries that do not have a financial and social environment similar to the UK's. Essentially, in order for a transition towards American-style corporate governance to take place on a reasonably prompt basis, lawmakers may need to "jump start" the process by establishing a regulatory framework that is hospitable to dispersed share ownership. Hence, while in the

corporate governance context, the law probably did not matter greatly in the UK, in other countries the story might well be different.

Notes

[1] Some financial economists have reasoned along similar lines (e.g. Johnson and Shleifer, 1999).

[2] On this, see Roe, 1994: ch. 1; Mark, 1995: 973-76.

[3] A controller, however, will not necessarily break up a control block in circumstances where a move to diffuse ownership would increase total value. On why this is so, see Bebchuk and Roe, 1999: 143-46.

[4] This account is derived from Cheffins, 2000, part 4.

[5] The number fell subsequently as a result of merger activity (Prais, 1976: 90).

[6] Some of the funds raised took the form of debt rather than equity. For statistics on the balance between the two, see Thomas, 1978: 35, 155.

[7] Part of the problem is insufficient evidence (Hannah, 1980: 52; Chandler, 1990: 628; Scott, 1997: 79-80).

[8] There was indeed something of a "boom/bust" cycle with respect to public offerings (Thomas, 1978: ch. 2).

[9] Some contemporaries in fact doubted whether private investors knew what they were doing (Macmillan Report, 1931: paras. 386, 387).

[10] The reference to English rather than British is intentional. The administration of justice in Scotland has many distinctive features (Cheffins, 1997: 308).

[11] See for instance, *Aberdeen Rly. Co. v. Blaikie Bros.,* (1854) 1 Macq. 461 at 471-72; Re *Smith & Fawcett Ltd.* [1942] Ch. 304 at 306; *Regal (Hastings) Ltd. v. Gulliver* [1942] 1 All ER 378.

[12] *Sub. nom. Dovey v. Cory* (1901) AC 477 at 488.

[13] [1902] AC 83 at 93.

[14] *Aberdeen Rly. Co. v. Blaikie Bros.,* (1854) 1 Macq. 461 at 471-72.

[15] *North-West Transportation Co. v. Beatty* (1887) 12 App. Cas. 589.

[16] The primary procedural obstacle was the "rule" in *Foss v. Harbottle* (1843) 2 Hare 461.

[17] On the first statutory measure of this type, see Companies Act 1948, s. 210. Also potentially relevant was the power which the Board of Trade had, after receiving an application from shareholders owning 10 per cent or more of a company's shares, to appoint an inspector (e.g. Companies Act 1929, s. 135). Such appointments were, however, rare (Cohen Report, 1945: para. 154).

[18] *Percival v. Wright* [1902] 2 Ch. 421.

[19] Directors' Liability Act 1890, 53 & 54 Vict. c. 64. Parliament enacted the measure in response to *Derry v. Peek* (1889) 14 App. Cas. 337, in which the House of Lords construed narrowly the common law tort of deceit (Samuel, 1933: 25; Mahoney, 1995: 1088).

[20] Companies Act 1900, 63 & 64 Vict. c. 48, s. 10(1).

[21] Companies Act 1907, 7 Edw. 7, c. 50, ss. 19, 21, which became operative in July 1908 (Cohen Report, 1945: para. 96). From 1929 onwards, companies were also obliged to circulate the balance sheet to shareholders (Buckley, 1949: 343, 965).

[22] "Provincial" stock markets in cities such as Birmingham, Manchester, Bristol and Newcastle were rivals to London's Stock Exchange (Thomas, 1973: 253-57; Michie, 2000: 235-39, 308-12). London's Stock Exchange was, however, the largest in the country and very much took the lead role as a supervisor of the equity markets (Cohen Report, 1945: paras. 23, 24; Gower, 1954: 292).

[23] The process began in earnest with the enactment of the Companies Act 1948, incorporating changes introduced by Companies Act 1947, 10 & 11 Geo. 6, c. 47. On the 1948 Act, see Arnold, 1948.

[24] See, for example, *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)* [1982] Ch. 204 and *Smith v. Croft (No. 2)* [1988] Ch. 114. On English judicial conservatism and the "law matters" thesis, see also Coffee, 1999*b*: 7.

[25] In 1993, Parliament amended the law to implement a European Union directive dealing with the topic: Criminal Justice Act 1993, c. 36, ss. 52-64, implementing Insider Dealing (Regulation) Directive, Directive 89/592, OJ 1989 L334/30.

[26] On the significance which enforcement of insider dealing laws has from a corporate governance perspective, see Bhattacharya and Hazem, 1999.

[27] The Companies Act 1929 did regulate the contents of the balance sheet to a certain extent (ss. 44-47, 124).

[28] The EU measure was the Fourth Company Law Directive, Directive 78/660, OJ 1978, L222/11.

[29] These measures followed on from Stock Exchange (Listing) Regulations 1984, SI 1984/716 and were enacted to implement the Admissions Directive, Directive 79/279, OJ 1979 L66/21 and the Listing Particulars Directive, Directive 80/390, OJ 1980 L100/1. See also the Prospectus (Public Offers) Directive, Directive 89/298, OJ 1989 L124/8, implemented by the Public Offers of Securities Regulations 1995, SI 1995/1537.

[30] Traded Securities (Disclosure) Regulations 1994, SI 1994/188; see also Interim Reports Directive, Directive 82/121, OJ 1982 L48/26 and Financial Services Act 1986, s. 153, which authorised the Stock Exchange to impose continuous disclosure requirements.

[31] Gower, in subsequent editions of his book, was less inclined to praise the Stock Exchange (e.g. 1969: 308-10).

[32] Another wave of regulatory reform concluded in 2000. See Financial Services Markets Act 2000.

[33] The Stock Exchange first gained this status via The Stock Exchange (Listing) Regulations 1984, SI 1984/716. In 2000, the Financial Services Authority replaced the London Stock Exchange as the competent authority under the Financial Services Act 1986. See Official Listing of Securities (Change of Competent Authority) Regulations 2000, S.I. 2000,No. 968

[34] An additional possibility is that investigations done by the financial press served to improve investor confidence (Gower, 1954: 438; Black, 1999: 17), but see Cohen Report, 1945,para. 26.

[35] Coffee in fact stakes out a somewhat different posiion. He argues that larger companies from countries with insider/control-oriented systems of ownership and control will create a hospitable environment for investors by listing on US stock exchanges (1999*a*: 673-83). Black (1999: 29-39) questions, however, whether such "piggybacking" will be feasible.

[36] Coffee (1999*b*: 7) has pointed out in a different context that the concentrated character of the UK financial community could be relevant when assessing the extent to which the law matters with respect to corporate governance.

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