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## Ownership, Governance and US Securities Regulation: The Case for a “Learning Regulator”

Aviv Pichhadze

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## **Ownership, Governance and US Securities Regulation: The Case for a “Learning Regulator”**

**Abstract:** I examine whether the Securities and Exchange Commission (SEC) in the US is a learning organization (i.e., one that is capable of learning and adaptation to the dynamic nature of the securities markets – the subject of the SEC’s regulatory oversight). Using the treatment of public corporate ownership in the proxy rules under the Securities and Exchange Act of 1934, I argue that the SEC is yet to become a learning regulator given that it has fallen short in learning of a distortion inserted into the regulatory framework in 1934, the result of which is the embedding of the distortion in the regulatory framework and its amplification via different policy initiatives. The consequence of imbalance between market realities and regulation is regulatory systemic risk.

**Keywords:** Institutional investors, ownership, corporate governance, securities regulation, SEC, law and economics, leadership, learning organizations

**JEL classification:** G23, G32, G34, G38, K22, L21, M14

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## Ownership, Governance and US Securities Regulation: The Case for a “Learning Regulator”

Aviv Pichhadze\*

### I. OVERVIEW

Mary Schapiro, Chair of the Securities and Exchange Commission (SEC), heads a considerable enterprise with a projected budget of US\$1.3 billion for 2011 (representing an increase of 18% over 2010) (SEC Press Room 2010) and approximately 3,500 staff (SEC 2010). Schapiro has the difficult task of carrying out the SEC’s tripartite mission of (i) protecting investors, (ii) maintaining fair, orderly, and efficient markets, and (iii) facilitating capital formation (SEC 2010) – a mission that is carried out for the implementation the SEC’s vision of becoming and being the “investor’s advocate” (Schapiro 2009b)

Schapiro took over the helm of the SEC in 2009 – a time when the organization was, and still is, attempting to reform its approaches to the regulation of the capital markets (Schapiro 2009b). This period corresponds with the aftermath of the deepest economic shock experienced by the capital markets since the Great Depression of the 1920s – an event that gave birth to the formation of the organization (SEC 2010).

While the SEC exhibits a realization that change in its approach is required, the nature of the strategic change it must undertake vis-à-vis regulation is still unfolding and involves the choice between two alternatives. On the one hand, it can adopt short-term changes with the hope of achieving rapid and tangible progress (see, e.g., Imai 1986). On the other hand, it can adopt longer-term changes that involve the SEC implementing (i) continuous improvement, reflecting the need for continuously improving the organization (see, e.g., Stacey 1993), (ii) continuous learning, reflecting the need for continuously improving – as well as challenging currently accepted – organizational knowledge (see, e.g., Argyris 1990 ; Senge 1990), and (iii) continuous adaptation, reflecting adjustment to external changes (see, e.g., Mintzberg and Westley 1992; Nonaka 1988). In short, the SEC must decide whether it is a problem-solving organization (i.e., one that is adopting short-term strategies for the purposes of responding to immediate concerns) or a learning organization (i.e., one that is adopting longer-term strategies able to meet near and longer-term demands). Here, a learning organization is one that is capable of adaptation and learning.

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Schapiro, it would appear, is cognizant of the need for the SEC to become a learning organization or a learning regulator and of the dangers associated with adopting short-term strategies in addressing the causes and consequences of the recent economic crisis (see, e.g., Schapiro 2009a). The question, however, is whether the SEC is, in fact, adaptive (i.e., capable of responding to the changes of its environment and the environment subject to its regulation) or exhibiting learning (i.e., able to improve its organizational knowledge).

One should be mindful of the fact that policy situations may involve many problems and issues that may be tightly interrelated. As a result, in some cases a solution to one issue may, in turn, require a solution to all the other problems. In other cases, each new solution may create additional wrinkles that may need to be addressed in the solutions to the other issues. Finally, very few, if any, problems can be isolated effectively for individual treatment (Mason and Mitroff 1981).

The complexities of policymaking (i.e., the interwoven nature of issues) are exemplified in the treatment of public corporate ownership in the US securities regulatory framework – a framework that is the subject of the SEC’s oversight. The reason stems from the fact that ownership patterns within a given economy affect many different areas of the regulatory framework and key governance arrangements (Bebchuk and Hamdani 2009; Kraakman et al. 2004). Consequently, any distortion relating to the treatment of ownership in one area of the regulatory framework may have implications that transcend into other areas of the system.

It is in the regulatory treatment of corporate ownership that we see evidence of partial organizational learning and adaptability on the part of the SEC. More particularly, through examination of (i) the theoretical basis of the proxy rules, in general, and (ii) one of the strategies proposed by Schapiro for the enhancement of shareholder protection in the context of the proxy rules in particular, I show that the SEC has come short of evolving into a learning organization/regulator. The analysis also points to the observation that absent learning and adaptability, the SEC is capable of, and actually is, introducing into the regulatory framework what Pichhadze (2010b) referred to as regulatory systemic risk – a risk resulting from the misalignment between policy initiatives and market realities which affects multiple areas of the regulatory framework.

The timeliness of the analysis in this article is of relevance as the SEC is currently “reviewing ... whether the U.S. proxy system as a whole operates with the accuracy, reliability, transparency, accountability, and integrity that shareholders and issuers should rightfully expect.”<sup>1</sup>

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<sup>1</sup> Securities and Exchange Commission, *Concept Release on the U.S. Proxy System*, 17 CFR Parts 240, 270, 274, and 275 [Release Nos. 34-62495; IA-3052; IC-29340; File No. S7-14-10] [“Concept Release”], at 7.

## II. ANALYTICAL BACKGROUND

The SEC was created by the Securities and Exchange Act of 1934 during the aftermath of the Great Depression of 1929 to restore public confidence in the public securities markets by providing investors and markets with reliable information and rules that ensure that investors are treated fairly and honestly (SEC 2010).

The SEC's philosophical emphasis on transparency for the sake of promoting investor protection "is shared by securities regulators around the world, as well as IOSCO [the International Organization of Securities Commissions] ... [which] has been instrumental in advocating and facilitating transparency throughout the world's capital markets, through the creation of numerous standards and principles promoting transparency in key aspects of the securities markets" (Schapiro 2009c).

One such set of principles or guidelines introduced by IOSCO is called the *Principles of Securities Regulation* (Principles). First introduced in 1998, the Principles provide for a general framework for the regulation of the securities markets and their participants to meet three objectives: (i) investor protection, (ii) ensuring fair, efficient, and transparent markets, and (iii) the reduction of systemic risk (IOSCO 2008). To meet these objectives, the Principles note that "the Regulator should review the particular way in which securities regulation is carried out because the markets themselves are in a constant state of development and the content of regulation also must change if it is to facilitate and properly regulate these evolving markets" (IOSCO 2008, 6).

In acknowledging the dynamic and evolving nature of the capital markets, the drafters of the Principles recognized that regulators need to foster a proactive approach to strategic change. Stated differently, while the mission/vision of the SEC may remain unaltered, its approach to attaining such mission/vision must evolve in response to the dynamic nature of the markets if it is to remain relevant.

To successfully address this need for change, the Principles require, it can be argued, that regulators perform two tasks: (i) regulators must improve their organizational knowledge by accumulating new knowledge as well as challenging currently acceptable organizational knowledge in order for such knowledge to remain relevant and (ii) they must adapt their approaches to ever changing market realities that are the subject of the regulatory framework. Both of these requirements, learning and adaptation, are mutually reinforcing and are intended to lead regulators to becoming learning organizations or learning regulators. That is, regulators are expected to engage in the process of "creating, acquiring, and transferring knowledge, and at modifying [their] behavior to reflect new knowledge and insights" (Garvin 1993, 80) and in detecting and correcting errors (see, e.g., Argyris 1977).

The call for regulators to become learning organizations has both organizational and economic implications. From an organizational perspective, learning means that the SEC (through its staff) must decide how to modify its processes to accommodate the changes in the marketplace

while maintaining (and achieving) its vision of being the investors' advocate and the tripartite set of objectives set out by IOSCO. To this end, Senge (1990) argued that the organization must come to terms with the tension created through the gap between the organization's vision (i.e., "where we want to be") and reality (i.e., "where we are").

To achieve this, the organization will need to engage in two types of learning: (i) incremental (or adaptive) learning, where knowledge is gained in a reactive manner after a problem has occurred, and (ii) continuous (or generative) learning, where knowledge is sought in a proactive manner in order to fix processes prior to the occurrence of a problem (Argyris 1977; Senge 1990). Thus, the process of becoming a learning organization entails a conscious organizational effort on the part of the SEC's individual members for the achievement of the organizational vision. As noted by Senge (1994, 48), "every organization is a product of how its members think and interact." As a result, the primary leverage for any organizational learning effort lies in people rather than in policies or budgets.

From an economic perspective, the requirement for the regulator to exhibit adaptation to market developments translates into the introduction of efficiency into the markets. This was observed by Williamson (2005), who distinguished between two types of adaptation that work together to achieve economic efficiency.<sup>2</sup> First there is "autonomous adaptation" exhibited by market actors in response to changes in the markets. In order to promote efficiency in the market, autonomous adaptation ought to be supplemented by "consciously coordinated adaptation" to be exhibited by administration (i.e., the regulator). Thus, in the context of governance, efficiency, according to Williamson, is the product of adaptive capacities of both markets and hierarchies.

As can be seen from the above, the requirement for the regulator to exhibit adaptation to changes in its environment means (from both organizational and economics perspectives) that the regulator needs to proactively engage in the learning process if it is to meet its organizational vision and objectives. The question to be answered is whether the SEC, through its actions, rises up to the task.

### **III. THE PROXY RULES IN THE US: DISTORTIONS, EMBEDDEDNESS, AND AMPLIFICATION**

To examine the question of whether the SEC displays (in practice) adaptability and learning it is suggested that we examine the treatment of corporate ownership within the regulatory framework administered by the organization. As noted earlier, the choice of ownership as the

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<sup>2</sup> While Williamson (2005) appears to be referring to adaptation in the context of the firm, I extend the application of the concept to cover the capital markets.

subject of examination is not arbitrary given its broad implications to many areas of the regulatory system.

Before turning to the examination of whether or not the SEC displays adaptation and learning, we need to observe the changes that necessitate the organization to foster strategic changes. Accordingly, I first describe the evolution in public corporate ownership in the US capital markets in brief. This is followed by an examination of whether the SEC successfully responded to this evolution in ownership. As the discussion will highlight, the SEC has been ineffective in achieving learning and, consequently, adaptation vis-à-vis the evolution in public corporate ownership, and heightened the hazard of introducing into the framework regulatory systemic risk (Pichhadze 2010b).

## A. OWNERSHIP – AN EVOLUTIONARY TREND

In the US, as the markets matured and grew in complexity, they have been evolving towards the Market Oriented Blockholder Model (MOBM). According to Pichhadze (2010a), the MOBM is a hybrid ownership structure featuring a blockholder mode of ownership<sup>3</sup> that works with market mechanism (e.g., takeovers).

This claim appears to contradict the general wisdom in the corporate governance literature, which teaches that the ownership pattern in the US is properly understood as dispersed. Nevertheless, an evolutionary analysis reveals that the American equity markets have gone through three stages of development, leading to the trend towards the MOBM (Pichhadze 2010a). A similar three-stage development has also been observed in the context of the UK (Gower and Davies 2003).

### 1. Stage 1 – Concentrated Ownership

During the early stages of the capital markets, ownership was concentrated in the hands of industrial elites and active investors (Jensen 1989: 65; Marshall 1890). These active investors defined American approaches to investment oversight (Pound 1992). The prevailing mode of corporate ownership utilized the venture capital model (Roe 1997), which worked with market mechanisms such as takeovers and mergers (Marshall 1890). Thus, we see that, during these early days of the US capital, markets market participants were able to marry a concentrated mode of ownership with market mechanisms such as takeover activity.

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<sup>3</sup> The spectrum of public firm ownership can be divided into three clusters: (i) concentrated ownership (ownership concentration  $\geq 50.1\%$ ); (ii) blockholder ownership ( $5\% \leq$  ownership concentration  $\leq 50\%$ ); and (iii) dispersed ownership (ownership concentration  $< 5\%$ ). The choice of the 5% threshold is based on the disclosure filing requirements under s. 13(d), Securities and Exchange Act of 1934, 15 U.S.C.A. Ch. 2B, that requires, inter alia, disclosure of beneficial ownership of 5% or more by any person of the outstanding shares of a firm's securities subject to Securities and Exchange Act. While the above are used as a general guide, these lines of demarcation are fluid and are subject to change from one firm to another based on factors such as size of the firm and shareholdings of individual investors.



## 2. Stage 2 – Limited Fragmentation of Ownership

During the early decades of the 20th century, observers noted the increased fragmentation in the ownership of America's largest firms as corporations sought to raise capital from a growing pool of investors (see, e.g., Carver 1925). This observation is largely associated with Berle and Means (1932), who, according to Tsuk (2005), were principally concerned with the power of large corporations. Large firms accounted for approximately 23% of the public firms in the Berle and Means study. The remaining 77% displayed blockholder ownership patterns (Berle and Means 1932, 27). As such, ownership during this period can be said to be "dispersed" to the extent that one confines the observation to large firms.

Roe (1997, 8) noted that the corporate ownership model at the turn of the 20th century (i.e., the venture capital model) was not adopted as the preferred ownership model for corporate America as a result of populist laws and interest group politics, which "played a key role in fragmenting stock ownership *beyond* what was required" [emphasis added].

## 3. Stage 3 – Towards the MOBМ

Fragmentation of corporate ownership (in large firms in particular) gave rise to two parallel market developments. The first development is the growth of institutional investors (IIs). The second development is the role of active investment as monitors of corporate managers. Both developments paved the way towards the MOBМ and represent Williamson's (2005) autonomous adaptation (Pichhadze 2010b). According to Williamson (2005, 4), "adaptation is the central problem of economic organization. Hayek focused on the adaptations of economic actors who adjust spontaneously to changes in the market. ... the marvel of the market resides in '*how little the individual participants need to know to be able to take the right actions*'" [emphasis added]. Thus, market actors are not required to have a conscious knowledge of the process. Let us consider each development in brief.

### *INSTITUTIONAL INVESTORS – GROWTH AND DISTORTION*

Throughout the second half of the 20th century, the ownership of public corporate equity began to re-concentrate into the hands of IIs; thereby institutionalizing the American securities markets (Cohen 1969). The institutionalization of the markets was encouraged by the US government, in part, as a response to changing socio-economic demands and needs (Naess 1964), and the process continues to the present day. The transformation in equity ownership from industrial capitalism to financial capitalism paved the way for the movement towards the MOBМ, which features IIs as blockholders.

The findings of Brancato and Rabimov (2008) illustrate the extent of the institutionalization in the US markets. For example, they show that total institutional assets increased from \$2.7

trillion in 1980 to \$27.1 trillion in 2006. Total institutional holdings increased from \$8.7 billion in 1950 (or 6.1% of total equity markets) to \$12.9 trillion in 2006 (or 66.3% of total equity markets). In addition, IIs have increased their holdings in America's 1000 largest firms from 46.6% in 1987 to 76.4% in 2007.

In relation to America's 25 largest corporations (ranked by market capitalization as of December 31, 2007), Brancato and Rabimov (2008) observed that these firms have a total institutional average holding ranging from a low of 52.9% in Exxon Mobil to a high of 85.4% in AIG. Of these 25 firms, 15 had at least one blockholder (i.e., investor owning 5% or more of the firm's outstanding shares). This list of 15 firms also includes AT&T, which Berle and Means (1932) used as their example of a dispersed giant corporation – indicating the change in the character of ownership in America's largest firms since Berle and Means published their widely cited study. In six of the largest 25 firms the largest investor held near blockholder levels (i.e., in the 4-5% range).

No less insightful is the observation made by others that “while there are many institutional investors, holdings are, in fact, concentrated in the hands of a relatively small number of the very largest institutional investors. For example, in the USA, the 100 largest fiduciary institutions hold fully 52 per cent of all publicly held equity” [emphasis in the original] (Hawley and Williams 2007, 415). Hence, not only is equity ownership concentrated in the hands of IIs, ownership is further concentrated within this class of investors.

Despite the fact that IIs experienced growth both in size and in influence (economic and political), Pichhadze (2010a, 71-72) turns our attention to an interesting peculiarity in the literature. The working hypothesis in the literature treats the US as a diffused ownership economy. An example of the working hypothesis can be found in the following statement by Bebchuk and Roe (1999, 133): “[a]t present, publicly traded firms in the United States and the United Kingdom commonly have dispersed ownership.” This working hypothesis, in turn, affected, as we shall see below, the views and understanding of regulators and policymakers who assume that the ownership pattern in the typical American public firm is diffused.

#### *ACTIVE INVESTING AS OWNERSHIP GAP-FILLING*

The fragmentation in public corporate ownership (in large firms especially) provided, it has been argued, for an environment for active investors to, inter alia, fulfill a governance function by filling the ownership gap (Pound 1992). Here, governance function means the monitoring of corporate managers.

According to this view, when the ownership of a public firm becomes too fragmented such that (i) the firm experiences a reduction in the effective monitoring of the firm's management, and (ii) such reduced monitoring results in the introduction of inefficiencies to the firm, then (iii) market mechanisms, such as takeover activity, introduce into the firm improved monitoring and enhanced efficiency by, among other things, concentrating, at least temporarily, the ownership of the firm (Pichhadze 2010b).

According to Pound (1992) this process is not an episodic event but, rather, a recurring one. More specifically, it appears to be a cyclical event that is part of the operation of the capital markets and is driven by market forces with the intention of eliminating inefficiencies in the marketplace and the firms operating within it. This is achieved through the provision of enhanced monitoring of listed firms while maintaining liquidity in the markets. Consequently, Pound (1992, 6) observed, “[t]he ultimate result is never revolution, but rather evolution.”

This evolutionary process appears to be one that splices blockholder components onto a market system in an attempt of achieving a governance structure that meets two market needs: (i) the need for improved monitoring of corporate management (associated with concentrated ownership) and (ii) the need to have liquid and efficient capital markets (associated with dispersed ownership). Under the traditional analysis in the literature these market needs are viewed as substitutes (Coffee 1999). Consequently, meeting these needs invariably involves the choice between tradeoffs that result from the choice of adopting one type of ownership structure (i.e., dispersed or concentrated) over the other. Under the conditions giving rise to the MOB, however, these tradeoffs are transformed into complements.

In addition to transforming substitutes into complements, given that a feature of the model is the presence of a blockholder, the observation of the trend towards the MOB may point to the proposition that market forces are attempting to reduce the sub-optimality associated with diffused ownership (such sub-optimality was suggested by Bebchuk and Zingales 2000). Accordingly, market forces can be said to, in effect, be attempting to arrive at an ownership equilibrium that affords both liquidity and monitoring, as well as structural optimality.

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

In addition to transforming substitutes into complements, the MOB appears to represent a socially optimal ownership structure, where social optimality refers to the idea that the shareholders’ representatives serve the shareholders’ interest (Grossman and Hart 1980). According to Grossman and Hart (1980), social optimality in the context of the corporation can be achieved in two ways (both of which are features of the MOB). One way of ensuring that social welfare is met is through the monitoring of managers by shareholders. The problem, according to Grossman and Hart (1980), is that absent anyone owning sufficient stakes in the corporation, monitoring is left to market-mechanisms such as takeovers. Yet, as the discussion in this article has shown, market forces and socio-economic realities created a venue for the

promotion of social optimality in the corporation. They have paved the way for the re-concentration of equity ownership into the hands of IIs. These shareholders (i) participate in the corporate control arena (both independently and in concert with active investors) and (ii) have sufficient stake in the corporation and, therefore, an interest in monitoring corporate managers. Thus, market forces appear to be reducing the costs associated with monitoring via voice (Deakin et al. 2006, 160).

Active investors, IIs, and the takeover structures that their partnership produce to acquire control in companies (i.e., private equity and leveraged buyout funds) appear, at a first glance, to be strange bedfellows. This is because active investors are said to have a negative image with both the public and the politicians (JACF 2006; Pound 1992; Roe 1997). On the other hand, IIs (i) enjoy, generally, the favor of the public, (ii) are viewed as part of the democratization of the public firm – as they are viewed as being the agents for the diffusion of the ownership of the public firm (Carver 1925; Hansmann and Kraakman 2004), and (iii) are viewed as the champions of shareholder rights and improved corporate citizenship (Hansmann and Kraakman 2004).

Despite this curious marriage between IIs and active investors, Holmstrom and Kaplan (2001, 132) observed that the institutionalization of the American equity markets played a key role in the emergence of the takeover wave in the 1980s. Thus, the need for (i) increased returns on investment and (ii) liquidity for their equity holdings drives IIs to PE; whereas the need for large pools of capital drives PE to IIs.

The growth of IIs in the US has cemented the gravitation towards the MOB – or the third stage of development in ownership patterns in the US. The MOB can be thought of as representing the result of the need of market forces to create an environment that facilitates enhanced monitoring of corporate managers, while ensuring liquid and efficient markets. In so doing, market forces have been facilitating the development of a variant of the blockholder model – a blockholder model that utilizes market mechanisms. This stands in contrast to other blockholder models discussed in the literature, which, generally, are said to exhibit a weak market for corporate control (see, e.g., Bebchuk and Hamdani 2009).

## B. OWNERSHIP AND THE FAILURE TO LEARN AND ADAPT

As noted earlier, IOSCO, the international standard setting organization for securities regulators, as well as economic and organizational theories suggest that the SEC, as the principal securities regulator in the US, take note of the evolutionary developments just described vis-à-vis ownership in the US and adapt its regulatory approaches accordingly.

Using the proxy rules in the US, the discussion will show that the SEC has failed in these tasks. More particularly, it is suggested that the SEC has internalized, embedded, and amplified two distortions in relation to ownership. First, through a misreading of Berle and Means (1932), the SEC has introduced a distortion into the regulatory framework vis-à-vis the appropriate tension to be resolved via regulations. This distortion became embedded and amplified with the growth of IIs – the second source of distortions within the regulatory framework.

## 1. Introduction of a Distortion

The proxy rules in the US are found in s. 14 of the Securities and Exchange Act of 1934. Sargent and Honabach (2009) observed that the proxy rules “derive directly from the Berle-Means description of the public corporation and the belief that managerialism represented a threat to public shareholders.” Briefly stated, Berle and Means (1932) observed that by the early 1930s the wealth of corporate America was concentrated in the hands of that nation’s largest corporations, and that these corporations have experienced a separation of ownership from control. Two observations were derived from this study in the literature and, consequently, adopted by regulatory circles. One relates to the ownership pattern in large firms. The other relates to the balance of powers within the corporation.

With respect to ownership patterns, Berle and Means noted that the largest firms in the US at the time displayed an atomistic pattern of ownership. Large firms in their study accounted for approximately 23% of the total listed firms. This observation about a fraction of the firms in the public markets, however, was generalized and internalized in the literature to encompass all of the firms in these markets. More importantly, the generalization became “Berle and Means recognized what was to become the dominant corporate paradigm of 20th-century American capitalism” (Edwards and Hubbard 2000, 92). With respect to the balance of power within these corporations, Berle and Means noted that the atomistic shareholders were under the influence of incumbent managers. Thus, the rules are premised on the view that the typical American public firm is properly characterized as having diffused ownership and, consequently, shareholders require protection from incumbent managers.

Since the introduction of the proxy rules in the 1930s, the foundation of the proxy rules has been based on this generalized (and misleading) corporate paradigm. The problem with the proxy rules being based on the Berle-Means Corporation rests in the failure of the regulator to appreciate the fact that the Berle-Means Corporation represented only a fraction of the firms when the rules were initially introduced in 1934 – a fraction which accounted for only 23% of the listed firms in the Berle and Means study. As such, the proxy rules focused on addressing the needs of shareholders in this small segment of the market. The remaining 77% of the firms that displayed blockholder types of ownership patterns, it would appear, were overlooked (and their needs were under-addressed) by policymakers.

This distorted view of the ownership patterns in the US had policy implications. First, regulators adopted Berle and Mean’s “unimportance” argument vis-à-vis non-large firms. Specifically, Berle and Means argued that the non-large firms in their study (or 77% of the listed firms) were unimportant given that they did not command any significant market power when compared to the large firms in their study (or 23% of the listed firms) (Berle and Means 1932, 28). Second, by importing this bias into the regulatory framework, regulators created regulatory gaps and introduced imbalance into the regulatory framework (Pichhadze 2010b).

The imbalance results from the regulator's primary focus on protecting shareholders from potential abuses by management (i.e., shareholder-manager type tension), which is associated with 23% of the firms in the Berle and Means study. Were regulators to design a regulatory framework that addresses the majority of the firms in the US capital markets, the attention of the regulatory framework would have been on protecting minority shareholders from potential abuses by blockholders (i.e., the minority shareholder-blockholder type tension) in addition to addressing the shareholder-management tension.

## 2. Embedding and Amplifying the Distortion

The above imbalance became embedded in the regulatory framework over time. This can be seen, for example, from one of Schapiro's recent initiatives designed to increase shareholder protection. Recently, the SEC adopted changes to the federal proxy rules by introducing a new rule called *Facilitating Shareholder Director Nominations* (Rule).<sup>4</sup> The Rule is designed to facilitate the rights of shareholders (either individually or as a shareholder group) to nominate directors to corporate boards by allowing shareholders to have their nominees included in the proxy materials.<sup>5</sup>

The difficulty raised by the Rule is that it is premised on the understanding that the US is characterized by diffused ownership and that the prevailing mode of corporate ownership is characterized by the Berle-Means Corporation. This view is supported by (and may be the product of) academic thinking that propagates Berle and Means' "unimportance" argument vis-à-vis non-large firms. As some commentators have argued, for example, "[t]he largest companies are very much giants among their corporate brethren. As a result, a separation between ownership and control remains an appropriate reference point" (Cheffins and Bank 2009, 52). Yet, this view overlooks the real tension to be resolved via legislation – the minority shareholder-blockholder type tension (Pichhadze 2010b).

Consequently, after nearly eight decades since the Berle and Means study, the SEC continues to base the proxy rules on the erroneous understanding that ownership in the US markets is diffused despite the fact that the institutionalization of these markets is well documented in the literature and despite awareness (and, at times, concern) by the SEC of the process.<sup>6</sup> Thus, it can be argued that, not only has the SEC failed in learning and adaptability, it further amplified distortions introduced into the legislative scheme in 1934 by failing to do so.<sup>7</sup>

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<sup>4</sup> 17 CFR Parts 200, 232, 240 and 249.

<sup>5</sup> The eligibility criteria to nominating directors include, among other things, such things as meeting an ownership threshold (either individually or in aggregate) of at least 3% and a holding period of at least three years continuously prior to the nomination.

<sup>6</sup> Pichhadze (2010a), for example, cites a number of studies commissioned by the SEC during the 1960s and 1970s to study the implications of the institutionalization of the US capital markets.

<sup>7</sup> While the Concept Release serves to indicate adaptability by the SEC to market realities, this adaptability is only partial given that it refers to the Rule in positive terms and, as such, it adopts the theoretical basis of the proxy rules as being premised on the Berle Means Corporation.

Amplification, in the context of the Rule, results from the fact that the threshold requirements are such that only a select group of shareholders can meet the requirements. This group consists mainly of IIs. Thus, that the overall effect of the Rule appears to be the empowerment of this class of shareholders. Given that IIs are generally treated in the literature as vehicles for the diffusion of public ownership (see, e.g., Carver 1925; Hansmann and Kraakman 2004), there is little surprise that the regulator is not careful in empowering this group of investors by ignoring evidence that fiduciaries are the emerging blockholders in the markets.

However, were the SEC to engage in the learning and adaptation processes, which include the reassessment of existing knowledge in light of new evidence, it is not certain that Rule would have come into existence in its present form. This is because the Rule magnifies the minority shareholder-blockholder type tension due to the nature of the blockholder (Pichhadze 2010b). For example, while some observers assume that IIs have interests that are homogeneous with other shareholders (see, e.g., Hansmann and Kraakman 2004), others note that shareholders are in fact a heterogeneous group with different interests (see, e.g., Anabtawi 2005-2006; Anabtawi and Stout 2008). As such, regulatory initiatives that may be suited for financial blockholders may not necessarily address the concerns of smaller shareholders.

Observing heterogeneity within the shareholder body is important due to the nature of the SEC's business – regulation. As such, the SEC is subject to influences from different groups that seek to advance their group specific interests – interests that may not be shared by other members of the capital markets. In the context of the proxy rules, it has been observed that since the 1980s IIs have sought to amend the proxy rules in several ways so as to gain greater influence on corporate decision making, including the ability to influence the election of corporate boards (Sargent and Honabach 2009).

Given that the Rule will effectively allow IIs greater influence on corporate decision making, it is not surprising that IIs supported the introduction of the Rule while it was in the proposal stages (Lynch 2009). This, however, may potentially detract from the sought after aim of protecting outside investors. As Bebchuk and Hamdani (2009, 1295) commented in the context of concentrated ownership, “giving the majority shareholders more power vis-à-vis the board would operate to weaken – not enhance – the protection of outside investors.”

#### **IV. THE RISK OF FAILING TO BECOME A LEARNING REGULATOR**

To this point in the article, the discussion highlighted the SEC's failure to exhibit learning and adaptability in relation to theoretical foundation of the proxy rules that were introduced in 1934 and in relation to the evolving nature of public corporate ownership in the US. In addition to the organizational and economic implications discussed above, this failure at becoming a learning organization also means that the SEC may be failing in meeting one of the objectives set out by IOSCO identified above – the reduction of systemic risk. The type of systemic risk

referred to here is regulatory systemic risk – a risk resulting from the misalignment between policy initiatives and market realities which affects multiple areas of the regulatory framework (Pichhadze 2010b).

To see how we arrive at this observation we, first, need to consider what is meant by systemic risk. In the context of the SEC's business – the administration of the regulatory framework for the securities markets – we can treat the regulatory framework as a system or as an aggregate of policies and regulations forming a connected or complex whole. Viewed in this way, systemic risk is a problem that pertains to the system (i.e., the regulatory framework).

Based on such an understanding, regulatory systemic risk can arise in cases where (i) policy initiatives do not align with market realities such that regulatory gaps are created, (ii) these gaps go unnoticed and become embedded in the regulatory framework, and (iii) the reach of the distortion(s) extends to multiple areas of the regulatory framework. That is, imbalances of a long-term nature which are systemic to the regulatory framework and result in regulatory systemic risk.

It would appear that Schapiro is cognizant of the possibility of introducing regulatory systemic risk into the regulatory framework of the securities market. Recently, Schapiro (2009a) distinguished between two types of systemic risk: (i) near-term systemic risk and (ii) long-term systemic risk. Near-term systemic risk results from seizures or cascading failures that threaten the stability of the financial markets. Factors that may create near-term systematic risk include, for example, catastrophic failure of major players (in the banking sector) and the inability to process or validate trades (in the securities industry). Longer-term systemic risk results from the unintentional bias towards larger institutions at the expense of smaller participants.

According to Schapiro (2009a), there is a causal relationship between these two types of risk given the hazard that in attempting to protect the financial system from near-term seizures, regulators can inadvertently introduce long-term imbalances into the regulatory system. To avoid such outcome, Schapiro suggests that we need to, among other things, address structural imbalances that facilitate the development of systemic risk by closing gaps in regulations. Stated differently, Schapiro appears to suggest that the regulator must engage in observation, learning, and adaptability – or be a learning regulator – in order to avoid the hazard of introducing systemic risk into the regulatory framework.

Yet, while Schapiro displays awareness of the need for becoming a learning regulator, the discussion in this article has shown that not only has the SEC failed in observing the distortion vis-à-vis ownership in the context of the proxy rules, Schapiro's own initiative (i.e., the Rule) points to lack of learning and adaptability to evolutionary trends in corporate ownership. This failure leads, in turn, to the creation of a new type of systemic risk – regulatory systemic risk. This risk, which arises from the introduction of imbalances into the regulatory framework via legislation that does not align with market realities, affects (or at least has the potential to) more than one area of the regulatory framework and as such impact the stability of the regulatory framework.



Regulatory systemic risk is illustrated by the treatment of ownership in the regulatory framework. While the discussion in this article focused on one aspect of the regulatory system, proxy rules, and the distortions embedded within it, a student of the area will realize that the impact of the distortion transcends into other areas of the framework. This is because ownership affects such matters as (i) takeovers and defensive measures adopted by firms to thwart such activity, (ii) conflict of interest rules and related party rules, (iii) significant corporate action and disclosure rules, and (iv) board independence (see, e.g., Bebchuk and Hamdani 2009; Kraakman et al. 2004). As such the distortion becomes systemic.

## V. CONCLUSION

Schapiro's task of restoring the public's confidence in the capital markets in the post-2007 market crash and carrying out the SEC's vision of being the investors' advocate is an important one. Yet, to meet the challenges presented by dynamic markets, vision alone is insufficient. To bridge the gaps between "where we want to be" (i.e., a regulatory framework that provides for (i) investor protection, (ii) fair and efficient capital markets, and (iii) reduces the potential of systemic risk) and "where we are" (i.e., a regulatory framework that contains embedded imbalances that result in regulatory systemic risk), requires "an accurate picture of current reality [which] is just as important as a compelling picture of a desired future" (Senge 1990: 9). As the discussion has shown, it is questionable whether the SEC is on track to bridging this gap.

This failure to become a learning regulator may also have industry implications, where industry means different securities regulators from different economies who are attempting to compete for domestic and foreign capital for the benefit of their respective markets. Some argue that competition between policymakers can lead to a "race to the bottom" (resulting in lower grade regulation for the sake of attracting capital into an economy) and "regulatory arbitrage" (resulting from firms selecting jurisdictions with lower regulatory barriers to raise capital). It is suggested, however, that the need for regulators to become learning regulators should result in a "race to the top" (resulting from regulators competing to offer a regulatory framework that offers minimal imbalances). Such a race to the top would mean that regulators will be able to offer a regulatory framework that is more conducive to the promotion of (i) investor protection, (ii) fair and efficient capital markets, and (iii) reduced systemic risk (including regulatory systemic risk) at both the domestic and global levels of the financial system.

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