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Commentary

HAROLD DEMSETZ RARELY FAILS to deliver a creative and thought-provoking paper, and this one is no exception. I have learned a great deal from Harold's writings over the years and usually find myself persuaded by his arguments. In this paper Demsetz explores the implications of certain restrictions on the behavior of financial institutions for the efficiency of the market for corporate control. This is a potentially important consideration and one that, to my knowledge, has not been systematically investigated.

The basic thesis of the paper can be summarized in three steps. The first step is to recognize that the diffusion of ownership of large corporations creates a control problem for owners (that is, stockholders). This well-known agency problem has long been the focus of intense study by economists. It is important to recognize, however, that the degree of diffusion of ownership reflects both costs and benefits to shareholders. The benefits arise from the reduction of firm-specific risk borne by owners through the diversification of their holdings. The costs arise from the potential loss of control over management.

The second step in the analysis is to argue that financial regulations limiting the extent of ownership in a corporation by certain types of institutional investors, including insurance companies, investment companies and commercial banks, potentially raise the costs of controlling management. The third step in the argument is to suggest that this reduced ability of owners to monitor and control managers reduces the efficiency of large corporations and thus tends to make them less competitive than corporations in countries where institutional investors are not subject to such restrictions.

I have no difficulty with the logic or thrust of this line of reasoning. It is rare that regulations are neutral and thus fail to distort resource allocations. The questions I am interested in focusing on have to do with whether the market has created alternative means of monitoring management. If so, then the question is, which means is most cost efficient?

Demsetz recognizes that concentrated ownership is not the only means of exercising control over management. Boards of directors provide important control mechanisms and have begun to reassert their authority. The recent cases of General Motors, American Express and IBM are good examples. Management compensation is another means to align management and shareholder interests. In general, the market for corporate control is an important monitoring device. Though it requires individuals or firms to obtain a concentrated ownership in a company, it does not necessarily depend on large financial institutions acting as the investors doing the monitoring. Large pension funds that are not regulated like banks or investment companies have become increasingly active in monitoring management. CALPERS is one of the most well-known funds and has been deeply involved in pressuring for management changes in several companies.

Demsetz stresses that there must be a cost to regulation that prohibits investment companies, insurance companies and banks from taking positions that encourage them to monitor management more closely. This is undoubtedly true. But it is an empirical question as to the importance of these restrictions. I would like to suggest that there may be reasons to believe the effects are small—if for no other reason than the marketplace is innovative in getting around such restrictions, particularly when there are large rewards for doing so.

Institutional investors can provide two sorts of services—risk sharing or diversification and management monitoring. There is no particular reason why expertise in one activity implies expertise in the other. In fact, it is easy to imagine that some institutional investors would specialize in one activity or the other. For example, Dean LeBaron of Batterymarch Funds and Rex Sinquefield of DFA view themselves primarily as portfolio managers. Neither of them seems to have the slightest interest in monitoring management. Why? Even though they must file 13d's indicating when they own a significant share of a particular company, probably only a small percentage of their portfolios is made up of companies of which they own a significant share. These fund managers specialize in risk sharing, not control or monitoring. Why should they have a comparative advantage in monitoring management? Just because they are skilled at managing risk does not mean they are skilled at management control. LeBaron has even pushed the idea of selling voting rights that would allow the separation and specialization in monitoring and risk sharing.

Why should one expect that managers of regulated insurance companies or investment companies have a comparative advantage in monitoring management? If they do not, the regulation is likely to have little substantive effect.[1]

Researchers sometimes feel that banks are different in this regard. Some view banks as having access to an informational advantage over other parties and thus being in a particularly good position to exercise control over management. Indeed, in Japan and to a lesser extent in Germany, this has been standard practice. If banks held both debt and equity then they would clearly have a strong interest in managerial monitoring. It is not clear, however, that they would always represent shareholder interests. It is worth recalling that the Glass-Steagall Act was not motivated by a desire to limit managerial control by banks but from a desire to stabilize the payments system involving the other side of the bank's balance sheet. In fact, certain types of banks are not subject to these limitations because they are not depository institutions, and they sometimes do take concentrated ownership positions.

The marketplace has clearly responded to the demand for corporate control through a variety of mechanisms and institutional arrangements that go far beyond the regulated financial intermediaries. In the case of monitoring management, new funds and partnerships have been created that specialize in seeking concentrated ownership for the purpose of control. One of the earliest of these was WESRAY, which was a partnership between William E. Simon and Raymond Chambers. They engineered successful leveraged buyouts (LBOs) for Gibson Greeting Cards, Avis and Wilson Sporting Goods. Kohlberg, Kravis and Roberts (KKR) is another successful partnership that specializes in obtaining concentrated ownership for the purpose of controlling management. In fact, by 1990, almost every major investment bank had created its own LBO fund (for example, J. P. Morgan and The First Boston Corp.). These funds and their managers specialize in ownership and control, not in providing risk sharing for investors. Thus it would appear that financial institutions and the market have responded to the demand for corporate control in innovative ways that circumvent some of the distortions caused by financial regulations on banks and other institutions regarding ownership.

There are other areas where regulation of financial institutions may be affecting the market for corporate control. Many of the LBO funds frequently obtain bridge financing from commercial banks. Unfortunately, under the Financial Institutions Reform, Recovery and Enforcement Act, banks are now much more limited in their ability to deliver such financing because of direct restrictions on purchases of high-risk securities and generally higher capital requirements. Thus, there remain potentially

[1] Of course, given the history of regulation, skilled monitors are likely to have migrated out of managing funds in these regulated firms.

important avenues for financial regulations on ownership to affect the efficiency of the corporate control market.

The final element I would like to comment on briefly is what, if anything, all this says about international competition. It is certainly true that U.S. corporations operate in a global market and that to the extent we reduce the efficiency or raise the costs of corporate control mechanisms serving to make U.S. companies better managed, we put ourselves at a competitive disadvantage. The two observations that Demsetz makes are that many other countries do not have the same restrictions on ownership by financial institutions and that in some foreign countries, structures are less diffuse than in the United States. Though both observations are potentially relevant, it would be more interesting if someone could gather evidence that linked the cross-country patterns of ownership and regulation to patterns of corporate performance and corporate control.

In summary, I think this is an interesting paper that helps focus attention on a set of issues that deserves more study. Regulations often have subtle and unintended effects and in some cases those may turn out to be of first-order importance. The issues discussed in this paper may fall into this category. Nevertheless, we must never underestimate the creative genius of market participants in circumventing regulations when large profit opportunities exist.