Where Berle and Means went wrong: a reassessment of capital market agency and financial reporting

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Abstract

This paper assesses the effects of Berle and Means’ study of the separation of corporate ownership from control on corporate financial reporting theory, research and policy. Their focus on shareholders and managers provided a starting point for the subsequent development of agency theory such that this relationship has come to dominate capital markets research and policy, to the virtual exclusion of parallel issues involving other parties. Berle and Means’ omission of the role of investment funds led them to conclude that the separation of ownership from control problems was located between shareholders and company managers. We document the inaccuracy of this conclusion using historical and contemporary US evidence and contemporary evidence for Germany, Japan, South Africa, and Canada. In contrast to Berle and Means, we find that investment fund influence and control over companies is pervasive and probably a common characteristic of modern capital markets. Our analysis shows how viewing the capital markets setting from a richer, two-tier perspective involving investors, investment managers, and company managers results in quite different and better perspectives on financial reporting issues, particularly in terms of company reporting to funds, and fund reporting to investors. Consequently, we suggest that our understanding of capital markets may be improved by studying and portraying more diverse types of parties and their relationships than just managers and owners. This perspective subsumes the single-tier principal-agent model and allows multiple relationships to be portrayed and studied. © 2000 Elsevier Science Ltd. All rights reserved.

1. Introduction

During the past twenty-some years, agency models have been widely used to portray economic relationships between (among others) shareholders and firm managers.\textsuperscript{1} In these models, firm managers are commonly represented as the agents of investors, while investment managers are modeled as financial intermediaries who facilitate information transfers, investing and monitoring activities.\textsuperscript{2} These basic relationships, which pervade much theoretic and applied capital markets research in accounting and finance, can be traced back to the pioneering work of Berle and Means’

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\textsuperscript{1} Watts and Zimmerman (1986) can be consulted for a review of this literature.

\textsuperscript{2} For instance, Leland and Pyle (1977) and Ramakrishnan and Thakor (1984).
Power without property: The rise of the modern corporation (1932). Berle and Means studied the development of the corporation and capital markets, characterized corporate ownership as consisting of dispersed individual shareholders, and found a separation between ownership and control functions within operating firms.

Berle and Means largely discounted or ignored investment fund influence and control of firms, and largely for this reason, modern agency theory focuses principally on the implications of the agency relationship existing between dispersed shareholders and firm managers. Although Berle and Means can scarcely be faulted for failing to anticipate the rise of the pension and mutual fund, their recent emergence and prominence implies an importance to reassessing the Berle and Means thesis and the models of corporate influence and control that have been derived from it.

In this paper, we reassess both operating and strategic influence and control relationships involving individual investors, investment funds, and operating firms, using an agency perspective, and present related reporting and disclosure implications. To fully incorporate influence and control functions, we follow Mintz and Schwartz (1985), among others, who define influence and control in both strategic and operational terms. We use the terms “investment fund” and “investment manager” interchangeably to refer to all sorts of funds and investing institutions (including mutual funds and pension funds) which invest aggregated resources of investors, and their managers. The term “investor” refers to noninstitutional parties, typically individuals, who place financial resources in investment funds.

Our investigation studies influence and control over corporations in two time periods: from approximately 1900 through 1932, and from approximately 1970 through the present. This analysis describes the nature and extent of investment managers’ activities in aggregating the resources of investors, in investing these resources in firms, and in exerting influence and control over these firms. We find numerous inconsistencies in the historical record in terms of characterizations of managerial control of firms and of investment funds as financial intermediaries, results echoed by contemporary, empirical studies. These findings show that the separation of ownership from control does not necessarily occur between stockholders and managers, due to the presence of investment funds, but also that a separation of ownership from control may occur between investment funds and investors. We conclude on this point that the underlying issue is one of concentrated versus dispersed interests, and not one of owners and managers per se. We use these findings and insights to portray the relationships among individual investors, investment funds, and company managers in a two-tier structure. In one tier this involves individual investors and investment funds, and in the other, investment funds and firms. This structure replaces the traditional

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5 The capacity of individuals to be direct shareholders is well understood and not considered further in this study.
6 We distinguish between property rights on one hand and influence and control on the other. Property rights relationships refer to the legal right of ownership in property. However, the de facto ability to exert influence and control over property may not arise from the legal ownership of such property. The corporate form of organization is a classic example of how property (ownership) rights can be separated from influence and control. Operating firm managers have the capacity to exert substantial control over property owned by shareholders. The point of our distinction is to emphasize an economic rather than a legalistic perspective on influence and control.
7 While it is well understood that the capital markets environment includes relationships among many parties, consideration of the relationships among capital managers, shareholders, and company managers has increased significance given the prominent role of capital managers in the capital markets, and the historical focus of accounting research (broadly conceived) on direct operating-company reporting to investors. For these reasons, focusing on these parties seems appropriate in this work.

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3 It is perhaps odd to realize that agency theory, as applied to the capital markets, while developing out of Berle and Means’ study, has a quite different solution than imagined by Berle and Means. The authors imagined legislation and a restructuring of corporate boards — such that board members were trustees to a broad set of interest groups, while agency theory identifies a possible economic, market solution to the separation problem.

4 This is a common view of influence and control. Mintz and Schwartz (1985, p. 8) define strategic influence and control by owners as that “in which the owners dominate decision making while relieving themselves of the daily exercise of the power they ultimately wield”. Other writers on this issue include Herman (1981, p. 115).
perspective of investment managers as financial intermediaries. Furthermore, it separates the ownership–control issue into ones involving the relationship between investment funds and individual investors, and the relationship between stockholders and managers. Although the idea of a multi-tier agency setting is not new, we note that it leads to financial reporting and research implications that differ from those of the traditional single-tier agency structure involving investors and firms that now dominate financial reporting research and policy, specifically in terms of firm reporting to funds, and fund reporting to investors. We observe that excluding significant capital market parties in the interest of parsimony and simplicity may result in analysis and policy that fails to address the interests of the excluded parties. Our results, therefore, pertain to other corporate claimholders, including employees, consumers, communities members, and other parties. While we do not assert that studies of capital market relationships need to portray all parties and relationships, we would argue that such portrayals should depend upon the focus and scope of each study, and not on arbitrary maintenance of model simplicity.

The remainder of this paper is organized in the following way. Section 2 reviews the Berle and Means thesis of managerial control of firms. Sections 3 and 4 examine the influence and control exerted by investment funds and their managers over firms during the first quarter of the twentieth century, during which time modern US capital markets emerged, and the most recent quarter century, during which time mutual and pension funds emerged as important forms of investment funds. Because the development of property and information rights has been shaped by a complex and dynamic interplay of factors over time, an historical analysis is exceptionally well suited as a method. It provides a rich perspective for a deep understanding of the many ways in which investment managers exert influence over firms across markedly different economic environments. Furthermore, our study uses historical methods and evidence to critically assess two widely held assumptions: first, the Berle and Means managerial control thesis, and second the investment-fund-as-financial-intermediary thesis. Our analysis focuses on the influence and control exerted by investment managers over firms during both periods. While we principally study US evidence, Section 5 addresses similar influence and control relationships observed in other countries. Following presentation of this history, Section 6 discusses and assesses the Berle–Means model and related agency structures involving investors and managers in a capital markets setting. We show how replacing the agency model with a structure that more richly portrays relationships involving shareholders, investment managers and firm managers leads to better understandings of financial reporting issues. Section 7 uses this perspective to consider implications in terms of firm-to-investment manager reporting and fund-to-investor reporting. We conclude in Section 8 by arguing for greater flexibility in portraying capital markets parties and relationships.

2. The Berle and Means thesis

In their classical work, The modern corporation and private property (Berle & Means, 1932) Berle, and Means sought to combine legal and economic perspectives in explaining the development of the “Modern Corporation”. Their main “separation of ownership from control” thesis suggested that, in the widely-held corporation, the risk-bearing function of ownership and the managerial function of control were separate functions performed by different parties. They viewed the corporation as “a means whereby the wealth of innumerable individuals has been concentrated into huge aggregates and whereby control over this wealth has been surrendered to a unified direction”. Berle and Means characterized management of industrial corporations as powerful and entrenched. Consequently, they argued that “the separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappears”. The Berle and Means thesis became a focal point for the subsequent development of capital markets agency thinking. Particularly significant was their
nearly exclusive focus on the relationship between shareholders and managers. It is plausible that Berle and Means merely conflated investment funds and their managers with firms and firms' managers, so closely were the two often portrayed during this time. The failure to form this distinction, however, led to subsequent research and a policy that focused on firm to shareholder disclosure issues, and virtually ignored investment fund–investor issues.

This characterization of management as all-powerful “princes of industry” could have been intended to highlight dramatic social changes wrought by the corporation rather than to accurately portray the structure of economic relationships at the time. In portraying the corporate system as involving the divorce of ownership or risk-taking from control, Berle and Means saw managers as enjoying many of the fruits of capitalism, without themselves providing much capital or undertaking proportionate risks. Instead, they were organizers and administrators. The advantages of the economies of scale that could be realized due to the technological revolution could only be mobilized by the accumulation of vast amounts of capital. For such large amounts of capital outside sources were needed. This led to the need for professional managers, who because of the dispersed nature of ownership, exerted effective operating control over firms. From this perspective, Berle and Means' focus on owners and managers might be regarded as a political or rhetorical device designed to focus attention on the problem of concentrated economic power in conjunction with the absence of some countervailing power. Indeed, as discussed later, Berle and Means suggested broadening the responsibility of a company’s board of directors to a kind of trusteeship to address the need for such a countervailing power. Some regard the passage of the Securities Acts as evidence of the success of Berle and Means' arguments. While many believe that the effects of the stock market crash and depression far overshadowed any such effect (Stigler & Friedland, 1983), the citation and word choices of politicians and regulators at the time of their enactment show that Berle and Means at least provided the rationale for such legislation.

Empirically, Berle and Means studied the largest 200 nonfinancial corporations of 1929–1930 and found that management controlled 44%. Another 21% were controlled by a “legal device”, so in total, Berle and Means calculated that about 65% of these large firms were nonowner controlled. To a large extent, Berle and Means attributed this condition to the emergence of widely dispersed firm ownership that accompanied the development of the large corporation. These findings were viewed as empirical confirmation of several prior writers’ observations on the separation of corporate ownership from control, including Veblen (1904), Veblen (1923) a quarter century earlier, Ripley (1927), and the Pujo Committee (1913). Writers such as Bell (1973), Galbraith (1967), Gordon (1945), Kaysen (1957), Marris (1964), Simon (1966) and Fama and Jensen (1983) have developed this thesis further. Furthermore, Berle and Means’ focus on the relationship existing between retail investors and firms has resulted in at least two important related theoretical contributions. The first of these is Chandler’s managerial capitalism (Chandler, 1977), which studies the control of firms by their managers. The second is Jensen and Meckling’s (1976) application of agency theory to capital markets settings, from which modern Positive Accounting Research has developed. The capital markets agency structure incorporates a shareholder/principal, and a manager/agent who is hired by the shareholder and to whom the manager reports. This application of agency theory to capital markets settings has been embraced by accounting and finance academics and policy makers, and has resulted in an emphasis in contracting, capital structure, and reporting and disclosure by firms to a dispersed group of owners. The capital markets agency model may be interpreted as the economic markets theory response to the issues raised by Berle and Means. Yet while inspired by Berle and Means, the agency “solution” is far from the suggestions proposed by them.

Despite the widespread use and influence of the Berle and Means thesis, many writers continue to question its descriptiveness. For example, while Mintz and Schwarz (1985, p. 8) acknowledge that “the acquisition of policymaking authority by the chief executive is seen by managerial theorists as more or less inevitable”, they view the control
issue as “problematic”. This problem necessitates an analysis of “the conditions under which outside controllers can successfully establish and change corporate direction”. Later in this paper we will return to more thoroughly reassess the Berle and Means thesis and related manager–investor agency model in light of the evidence presented below.

3. The early corporate economy — the J.P. Morgan era

3.1. Economic environment

We begin by tracing important business and economic developments in the late nineteenth/early twentieth century. We focus on the development of US capital markets and the role of investment funds, particularly investment bankers, in conjunction with an assessment of the Berle and Means thesis of a separation between ownership and control.

The rise of the industrial giants in the United States coincided with the peak of the country’s drive to industrialism after the 1880s (Chandler, Bruchey & Galambos, 1968). Previously, the existence of innumerable small business firms resulted in decentralized resource allocation decisions. Centralized coordination and control of production now replaced this approach. The US economy was swiftly transformed from a strictly agrarian, commercial and rural economy into an urban, industrialized one. It experienced enormous growth. While in the 1850s the industrial output of the US was far below that of England, by 1894, the value of American products almost equaled the value of the combined output of the United Kingdom, France, and Germany. By the First World War, America produced more than one-third of the world’s industrial goods (Chandler et al.).

Thus, within a relatively short span of time, there was a dramatic transformation of an undifferentiated economy to a differentiated and complex one. It is not surprising, then, that the American economy experienced fundamental structural changes at the same time. As related to business entities, the integration of ownership and control that was characteristic of the nineteenth century firm gave way to their separation, initiated by the development of railroads (Chandler, 1969).

It is well known that this enormous expansion of the American economy occurred in conjunction with a corresponding need for investment resources. Capital markets, as we understand them today, did not exist. However, banking houses, like J.P. Morgan (among many) did, and it is these parties that we refer to as investment managers and investment funds during this period. Bankers like J.P. Morgan played a central role in this expansion due to their ability to mobilize large amounts of capital (DeLong, 1991). The capital needed to develop railroads was provided in a large part by the flotation of bonds, which, in turn, led to the rise of the Wall Street investment banks (Chandler & Tedlow, 1985) and, subsequently, to national and regional stock market development.

3.2. Investment funds

The Berle and Means thesis, however, largely overlooks the dominating presence of investment managers during this early market. Investment managers played a pivotal role in the development of early capital markets, where they were important in the resource allocation process. Firms such as J.P. Morgan were instrumental in financing corporate acquisitions, mergers, and other activities (Brandes, 1914; DeLong, 1991; Goldsmith, 1954; Pujo Committee, 1913; Ramirez, 1995). Often, investing activities extended to strategic and even operational influence and control of firms. While the source of the funds used for financing these activities were typically bank deposits and insurance funds held by firms controlled by Morgan or other financiers, depositors, and insureds were probably relatively uninformed of the use of their funds by the investment managers (similar to many mutual fund investors and pension plan participants of today).

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8 That is, both the depositor of the early twentieth century and the mutual fund holder of the late twentieth century provided the “atomic” basis for resource aggregation, without, in either case, having much of an idea about what was actually done with their funds.
While the record of investment managers’ control over firms is too broad to exhaustively review, the illustrations below are characteristic of their activities. Morgan’s early major activities predate, of course, the turn of the century (see Chandler & Tedlow, 1985), and began with the railroads. By way of background, an economic depression in the 1890s led to a series of railroad reorganizations. In these transactions, the Morgan firms typically acted as managers of large underwriting syndicates, which normally agreed to purchase securities — stock, convertible bonds, or convertible notes not bought by the corporation’s shareholders in an offering. The general reorganization pattern consisted of raising cash through the issue of new securities, realigning fixed charges by exchanging new securities for old, predicated upon the earning capacity of the corporation, and the creation of a voting trust. The voting trusts, appointed by the reorganization committee, were vested with full corporate authority by the shareholders. Thus, Morgan wielded significant control over railroads, on behalf of shareholders, through the vehicle of the voting trust. These trusts served to separate the voting and ownership rights inherent in common stocks.

The Morgan company was omnipresent throughout the early development of American capital markets. Between 31 December 1897 and 22 January 1913, J.P. Morgan & Co. was the sole underwriter for 11 interstate railroad issues of stock and convertible bonds totalling almost $63 million. In another 4 instances, the firm managed underwriting syndicates totalling over $204 million. In 122 instances, it acted as initial subscribers for bonds and notes totalling $204 million. In 122 instances, it acted as initial subscribers for bonds and notes totalling $204 million. In another 61 instances, it managed subscription syndicates which placed securities totalling over $485 million (Chandler & Tedlow, 1985, p. 272). As managers of syndicates, J.P. Morgan & Co. sold securities of the syndicate either through private placement or public subscription for an additional commission and share of profits. These functions were of central importance in an economic system with relatively undeveloped capital markets.

The syndicate operations were based on faith, reputation, and character, all of which were essential factors in the development of early capital markets. The growth of the railroads led to innovations in the techniques of creating and managing large private business enterprises. Modern finance and administration techniques, labor relations and government regulation changed dramatically. The demand for capital to feed the immense growth in America’s big business led to the institutionalization of the nation’s money market in New York.

Morgan turned his attention to other industrial enterprises around the turn of the century. From 1902 to 1912, J.P. Morgan & Co. was directly responsible for marketing almost $2 billion of interstate securities. It also ran a large commercial banking business, with aggregate deposits in 1912 of $162 million. The Morgan Company became best known for its roles in organizing five firms: General Electric, American Telephone and Telegraph, Federal Steel, United States Steel, and International Harvester. In these cases, the need for capital and the fragmentation of the industry (particularly in the case of AT&T) resulted in a close relationship between the company and its bankers. Morgan involvement in a firm or industry required extensive refinancing, including the flotation of new securities in the New York market (Sobel, 1965). Investment bankers of this time, believing that small investors were prone to panics, turned to other banks, trust companies and insurance companies as new sources of funds. This, in conjunction with the merger movement, the growth of larger enterprises, and the need for large-scale financing, resulted in “a complex of investment commercial banks together with life insurance trust companies … with enough resources to control the market under almost any circumstances…” (Sobel, p. 184). Thus, the merger movement that began with the railroads in the 1880s, and which thereafter spread to the industrial firms, was facilitated to a large extent by a small group of private bankers including J.P. Morgan. These financiers fostered combinations in capital intensive industries with the purpose of bringing the market under control.

Morgan’s restructuring of the steel industry into the United States Steel Corporation, the first billion-dollar firm, illustrates the operational influence and control exerted by investment managers of the period. This combination, considered by many to be the greatest merger of the era (Sobel, 1965),
resulted in a union of eleven major firms and contained what were once 170 independent firms. The firm was formed in 1901, and soon after its incorporation, Morgan announced the formation of a syndicate to underwrite new securities. The circular noted that “the entire Plan of Organization and Management of the United States Steel Corporation shall be determined by J.P. Morgan & Co.” (Chandler & Tedlow, 1985, p. 282). Not only did Morgan orchestrate the creation and financing of US Steel, he also handpicked its manager. It is known that George Perkins, a Morgan partner, served on its finance committee and designed the company’s innovative employee stock purchase and bonus plans, and that Morgan himself was involved in mediating labor disputes. Carosso (1987, p. 473) writes “As sole managers, with complete authority over all its operations [Morgan’s firm] was responsible for every aspect of the steel corporation’s organization.” Furthermore, Morgan & Co. made a 200% return on the funds advanced during the merger, received substantial fees, and created a firm which controlled a majority of the various businesses that made up the steel industry.

The formation of International Harvester also illustrates investment banker strategic and operational control of a firm. Formed in 1902 in a merger of five companies, the stock of International Harvester was placed in a voting trust controlled by the Morgan Company (Garraty, 1957). Carosso (1987, p. 480) notes “[The Morgan Firm] alone would determine the structure of the merged company and who had the right to choose its officers and directors…” The company was effectively run by Morgan partner George Perkins, who wrote to Morgan, “The new company is to be organized by us; its name is to be chosen by us; the state in which it shall be incorporated is left to us; the Board of Directors, the Officers, and the whole outfit left to us — nobody has any right to question in any way any choice we make” (Chernow, 1990, p. 109). Carosso (1987, pp. 490–491) concludes that Perkins’ position in the company “allowed him great power, which he used to make personnel decisions, define the authority of various offices, and determine some of the corporation’s basic policies…”

Morgan and Company’s activities were not limited to US Steel sized companies. For example, the company organized and underwrote 145,000 preferred shares and 72,500 common shares of American Bridge, organized under a five-year voting trust, and loaned working capital or subscribed for shares of Associated Merchants, Harper & Brothers, Hartford Carpet Corp., and Virginia–Carolina Chemical Co. After 1907, among other transactions, Morgan managed an $8 million bond subscription of US Rubber Co., and purchased securities of firms as part of issues managed by another firm, Lee, Higinson, & Co. (Chandler & Tedlow, 1985, p. 280). His work with Rockefeller’s Standard Oil involved the formation of a series of horizontal and vertical combinations that controlled about 90% of the domestic industry (Galambos & Pratt, 1988). Smith and Sylla (1993, pp. 3–4) write: “Morgan and other Wall Street bankers became intimately involved with not only the creation but also the shaping and governance of big business enterprise.”

A common vehicle for instituting and perpetuating control over companies was the investment trust (which should be distinguished from its 1920s period progeny, investment and holding companies). Investment trusts commonly involved placing the voting securities of one or more corporations under the control of a voting trust, the trustees of which were, invariably, investment bankers. Morgan’s Northern Securities is instructive in this regard, being the vehicle used to exercise control over Great Northern, Northern Pacific, and other railroad company stock. This form of investment trust was the basis of popular, progressive criticism and led to the Supreme Court’s breakup of Northern Securities under the Sherman Antitrust Act. Subsequent investigations and accounts provided by former financiers such as Thomas Lawson (1904) regarding the control by “organized finance” over insurance and other large corporations showed the pervasiveness of control exerted by such organized groups over companies.

From today’s perspective, the early corporate economy consisted of a comparatively small number of large corporations, and small groups of financiers, the “Money Trust”, who in turn, mobilized the savings of a large number of individuals and made resource allocation decisions. This
money trust had a large and important presence in the capital markets that formed the context of Berle and Means’ analysis of the corporation. They performed vital functions in the economy, which resulted in a concentration of economic power in their hands. However, Berle and Means did not address the role of investment bankers, insurance companies and underwriters as agents of managerial capitalism. Their analysis, therefore, did not fully portray influence and control relationships, particularly in terms of either acknowledging this role, the relationship of the investment bankers to firms or individual investors, or in distinguishing between firm managers and their investment bankers.

3.3. The money trust

The Pujo hearings on the “money trust” are illustrative in assessing the position of investment managers in the capital markets of the period. These hearings were held with a view to determining whether something in the nature of a “money trust” existed, and whether, as a result, a small group of Wall Street Bankers dominated the economy. The majority report issued in February 1913 asserted “a high degree of financial concentration...and a close alliance between the heads of a few New York City banks and the principal users and suppliers of capital” (Carosso, 1973). This control over the resources of the investor was effected through gaining representation on corporate boards, controlling through stock ownership the savings represented in life insurance companies, savings banks and trust companies, and by developing a syndicate system, which consisted of various techniques of originating, underwriting, and distributing new securities. There existed a complex network of economic relationships at the center of which was the “money trust”.

The investment managers of the period scarcely denied and, in fact, argued for the necessity of such involvement (Pujo, 1913, p. 106). This involvement went far beyond what is commonly associated with “financial intermediation”, but rather better mirrored what Mintz and Schwartz (1985) describe as strategic and operational influence and control. DeLong (1991, p. 217) asserts that “[t]he forty-five employees of Morgan and Company approved and vetoed proposed top managers, decided what securities they would underwrite, and thus implicitly decided what securities would be issued and what lines of business should receive additional capital.” Following Morgan’s death in 1907, Pratt (1913) wrote, “no man ever controlled the money of other people in such sums as [Morgan] did...His power is not to be found in the number of his own millions, but in the billions of which he was the trustee.” Chernow summarizes the extent of this influence and writes:

Some 78 major corporations, including many of the country’s most powerful holding companies, banked at Morgan. Pierpont and his partners, in turn, held 72 directorships in 112 corporations, spanning the worlds of finance, railroads, transportation and public utilities...” (Chernow, 1990, p. 152).

Even following the Northern Securities decision, the Morgan Company remained a powerful force in corporate finance, underwriting $6 billion in securities between 1919 and 1933 (Chernow, 1990, p. 257) and the firm continued to be involved in both strategic and operational influence and control over firms. Notable among its activities was its 1920 collaboration with the DuPonts to wrest control of General Motors Corporation from William Crapo Durant. Morgan partners remained influential members of the boards of directors of major corporations and were active participants in the major strategic and operating decisions of many others, including AT&T. Even at the time of the Pecora hearings, during the 1930s, it was revealed that Morgan partners sat on the boards of directors of 89 corporations. Pecora asserted that this represented the greatest reach of power in private hands in our entire history” (Pecora, 1939, p. 36).

3.4. Investment trusts and holding companies

As the “retail” market for corporate securities developed, other forms of institutionalized investment evolved. The 1920s saw the rise of investment trusts and holding companies, typically sponsored by banks (or their subsidiaries) and investment and brokerage houses. Small investors
invested money in these firms much as individuals today invest in mutual funds [although the lines between banks and investment trusts were sufficiently vague that many individuals undoubtedly believed they were putting their money in the banks themselves (Galbraith, 1955, pp. 48–70)]. By 1927, Wall Street investment trusts sold $400 million of securities, and in 1929, they marketed securities amounting to $3 billion, or about a third of all issues. By the autumn of 1929, their total assets were estimated to exceed $8 billion. This constituted an elevenfold increase between 1927 and 1929 (Galbraith, 1955, p. 55). By 1929, a number of different kinds of concerns were bringing these trusts into existence. Investment banking houses, commercial banks, brokerage firms, securities dealers, and most importantly, other investment trusts, were “sponsoring” the formation of new trusts.

What were the benefits of sponsorship? The sponsoring firm in general executed a management contract with the investment trust it sponsored. The sponsor also administered the trust, invested its funds, and was paid a fee based on capital or earnings. If the sponsor was a stock exchange firm, it received, in addition, commission on the purchase and sale of securities. Many of the sponsors were investment banking firms. The sponsoring of trusts ensured that they had a steady source of business. The investment bankers that sponsored these trusts, including Morgan, offered them for sale to friends at depressed “bargain” prices, which practically ensured a high profit in the markets soon after. Galbraith (1955, p. 56) observed: “that such agreeable incentives greatly stimulated the organization of new investment trusts is hardly surprising”.

It is apparent that in the early capital markets, a premium was paid for financial entrepreneurship. The market value of the outstanding securities of investment trusts and holding companies was far higher than the sum of the values of the individual securities owned. The property of these organizations consisted solely of common and preferred stocks and debentures, mortgages, bonds, and cash. Sometimes, their securities were worth twice the value of the property owned. The premium was, in Galbraith’s view (1955, p. 59) “the value an admiring community placed on professional financial knowledge, skill, and manipulative ability.”

Trusts and holding companies also sought to differentiate themselves by leveraging their capital structure (Galbraith, 1955, pp. 61–69). Investment trust’s leverage in this regard was achieved by issuing bonds, preferred stock, and common stock to purchase almost exclusively, a portfolio of common stocks. This “intermediation” systematically affected the control of property (capital stock and bonds) in the markets. “The magic of leverage” (Galbraith, 1955, p. 62) also provided the common stockholders of these trusts with the potential for unlimited gains, which was compounded geometrically as trusts invested in other trusts. It was possible, using networks of investment trusts, for single individuals to control disproportionately large parts of the capital markets. For example, Harrison Williams was thought by the SEC to have control over a combined investment trust and holding company system with a market value in 1929 at close to a billion dollars (Galbraith, 1955, p. 64). So called “super holding companies”, such as Morgan and Bonbright’s; United Corporation, controlled utilities providing 27% of the nation’s electrical output [Federal Trade Commission (FTC), 1935]. Other immense Morgan sponsored and controlled holding companies included Standard Brands, for food-producing companies, and Alleghany Corporation, for railroads and real estate. The line between a holding company and an investment trust (presumed not to have direct control) was often nebulous. The risks of leverage were not apparent before 1929,9 and numerous businesses including American Founders Group and Goldman Sachs turned to leveraging themselves to achieve remarkable growth.10

In their analysis of the corporation in terms of the separation of ownership and control, Berle and Means did not address the role of investment funds in the patterns of corporate ownership,

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9 By 1930, of course, the unraveling of this leveraging was painfully apparent.
10 It is interesting to compare the excessive use of leverage in the 1920s with that of the 1980s. There are clearly some differences — the earlier case representing what was essentially a pyramid scheme, while the latter (ostensibly) related to scale, agency, and tax issues. More cogent to this paper is the observation that both required the active participation of the investment banking community.
influence and control. As outlined above, managerial control of corporations was diluted by the complex nature of various institutionalized structures including investment banks, holding companies, and trusts, which led to significant control of operations by the investment bankers and financiers. In turn, the funds used by these investment managers were provided, wittingly or not, by individuals through direct investment in trusts, or through insurance companies, or banks.

The basis of Berle and Means’ analysis is perhaps best understood by considering that they wrote during a period in which the “retail” market for corporate securities developed, in part due to the energies of Merrill Lynch and other emerging brokerage firms. This highly visible growth in the “retail market” for corporate securities provides a perspective for understanding Berle and Means’ focus on individual investors and the corporation. Despite, however, the dramatic appearance of the individual investor, the bulk of investment in corporate securities continued to occur through investment funds.

Berle and Means’ analysis of corporate ownership/control relations leads them to conclude that the balance of control shifted entirely in favor of the professional manager. Yet, while most small, individual investors of this era did not have much direct financial control, one view on the presence of the bankers is that they provided countervailing power against managerial control over firms. Another is that they operated at the expense of individual investors and the public.

It is unclear whether Berle and Means viewed the investment bankers as distinguishable from firm managers. While Berle and Means’ analysis is correct in identifying the control attained by professional managers with respect to individual investors per se, their conclusions are limited by the omission of institutionalized forms of corporate control in their analysis. The scope of activities of investment managers took them well beyond the function of financial intermediation. They were orchestrators of the managerialist corporate system, involved in exercising both strategic and operational influence and control over firms. To the extent that they proved to be of greatest benefit to owner–managers through their ability to provide the financial support and climate conducive to the long-term viability of their enterprises, they could be considered to be “proprietor capitalists.” From this perspective, the agent of the individual was not always, in fact, corporate management, but often the investment bankers and trust managers. Indeed, the bankers, at least, proved to be important monitoring agents against opportunistic behavior by corporate management (Carosso, 1973). The investment bankers also had vested interests in the success of these corporations, providing them with new avenues for investment and fee income. The growth and development of the investment banks therefore paralleled that of corporations during this period.

4. The modern fund era — post 1970

4.1. Economic environment

In this section we first review the development and extent of modern institutional ownership of firms. Then we document investment funds’ contemporary influence and control over firms with empirical evidence and cases. While there are fundamental differences between the American economy in the first and second periods studied, the ubiquity of investment managers and institutionalized forms of capital of various sorts continues, and indeed has even grown, in the modern forms of pension funds, mutual funds, insurance companies, and other institutional vehicles. It is these parties that we refer to as “investment funds” during this second period. Banks, in contrast, had a dramatically different relationship with firms following the passage of Glass–Steagall, and we consider their continuing influence and control abilities over firms only briefly.

Following the stock market crash of 1929, the disastrous results of bank involvement with holding companies and investment trusts became evident, and beginning in the 1930s, Glass–Steagall and other securities acts and regulations restricted bank investing activities. It was thus from this point through the 1950s that the Berle and Means world of dispersed ownership was most nearly true. At one point during the 1950s, it is estimated that investment funds owned something less than 10% of corporate equities. But during the prosperous
period following the end of the Second World War, a number of nonbanking and nondepository institutions such as insurance companies, pension funds, and mutual funds became important securities holders. Even in the 1950s, and all the way up through 1980, the Securities and Exchange Committee (cited in Allen, 1985) estimates show that a quarter to a third of all US shares were held by investment funds.

4.2. Investment funds

Between 1980 and 1990, fund ownership of equities dramatically increased to more than 50% (Brancato & Gaughan, 1991). By 1990 more than half of the Business Week’s Top 1000 firms had greater than 50% ownership by institutional investors (Brancato & Gaughan). Furthermore, this institutional ownership was highly concentrated; for example, the largest 20 pension funds represented nearly a quarter of all pension fund assets in 1990 (Brancato & Gaughan). Investment funds now hold more than half the value of publicly traded US equity, and account for more than 70% of the volume of US traded equities.11 Between the 1965 and the 1990, “large block” trades rose from just 3% of all trades to roughly half (Smith & Sylla, 1993). Also, the number of noninstitutional parties investing directly in corporations has declined dramatically over the past decade. As reported in the Economist (1990) American private investors reduced the net value of their equity holdings by about $550 billion between the end of 1983 and the end of 1989, which is equivalent to 40% of their portfolios in 1983. “Were these trends to continue, the last American to own shares directly would sell his last one in the year 2003” (Economist, 1990).

Pension funds emerged as principal owners of American equity capital in the early 1970s (Drucker, 1991). Employees became owners through the medium of a fairly small number of large “trustees”. While these pension funds traditionally viewed themselves as investors (punters), with a short-term focus, they found themselves increasingly thrust into the position of owners (proprietors) simply due to their sheer size (Economist, 1990). Table 1 shows the increase in financial assets held by pension funds from 2.5 to 4.2 trillion dollars between 1990 and 1995. The most dramatic increase, however, occurred in mutual funds. As mentioned in the paper’s introduction, the number of mutual funds has grown from about 1000 in 1983 to about 5000. By 1995 mutual funds held about 23% of all US financial assets [Organisation for Economic Co-ordination and Development (OECD), 1997]. Mutual fund ownership of stock rose from about 3.1% in 1980, to 12.8% in 1996, and the total value of their financial assets reached over 2.7 trillion dollars in 1996 (OECD, 1997). Table 1 summarizes the financial asset holdings of major types of investment funds between 1990 and 1995.

4.3. The regulatory environment

Changes in administrative and regulatory rules, particularly in the form of corporate governance mechanisms, investor communications, and block trading, have increased the ability of investment funds...

---

Table 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Insurance companies</th>
<th>Mutual funds</th>
<th>Pension funds</th>
<th>Other institutions</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>1091</td>
<td>1155</td>
<td>2531</td>
<td>1409</td>
<td>6996</td>
</tr>
<tr>
<td>1991</td>
<td>2081</td>
<td>1376</td>
<td>2848</td>
<td>1589</td>
<td>7894</td>
</tr>
<tr>
<td>1992</td>
<td>2212</td>
<td>1624</td>
<td>3152</td>
<td>1664</td>
<td>8652</td>
</tr>
<tr>
<td>1993</td>
<td>2427</td>
<td>2045</td>
<td>3429</td>
<td>1811</td>
<td>9712</td>
</tr>
<tr>
<td>1994</td>
<td>2565</td>
<td>2191</td>
<td>3565</td>
<td>1881</td>
<td>10,202</td>
</tr>
<tr>
<td>1995</td>
<td>2829</td>
<td>2727</td>
<td>4156</td>
<td>2160</td>
<td>11,871</td>
</tr>
</tbody>
</table>

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a Constructed from OECD data (OECD, 1997).
b “Other institutions” include bank trusts, finance companies, real estate investment trusts, and security brokers and dealers.

11 In addition to being significant debt owners.
funds to influence firms. Important rule changes included provisions related to proxy solicitations and voting, shareholder communications, shareholder proposals (Rule 14A-8) and the 1992 relaxation of communication rules for larger shareholders (in part due to pressure from The California Public Employees Retirement Systems — “Calpers”). Blair (1995, p. 72) relates the 1993 use by institutional investors of these new communication rules, specifically in communicating with one another and in coordinating their influence over Medical Care America. In addition, the federal government encouraged, and even required, investment fund involvement in firms whose securities they hold. For example the Labor Department has ruled that pension funds must vote their shares as a part of their fiduciary duty in the “economic best interest of a plan’s participants and beneficiaries” (Department of Labor, 1989). Federal encouragement of pension fund involvement in firm activities continued to increase through the late 1990s.

Other rule changes, such as the SEC’s rule 144a, adopted in 1990, has made it easier for large firms to sell their securities to large “qualified” buyers, defined as institutions with at least $100 million invested in securities. Rule 144a exempts many privately placed deals from SEC registration requirements. In 1992 changes to 144a were approved allowing institutions seeking to meet the $100 million requirement to include government securities in their portfolios. As a result, it is now possible for bank and pension trust funds and some insurance accounts to buy unregistered bonds and stocks, expanding the scope of institutional influence.

Capital market structures have also evolved in a manner favoring investment funds. Partly as a result of competitive pressures from regional exchanges, electronic networks such as INSTINET and off-exchange markets, the NYSE in 1992 adopted the “clean-cross rule” allowing large institutional investors to sidestep floor trading on trades of 25,000 or more shares furthering the development of a two-tier stock market.

4.4. Evidence on influence and control

The regulatory and administrative changes described above, coupled with the huge growth in pension and mutual funds, have dramatically increased the ability of investment funds to influence firms. What is now characterized as “fund activism” has increased since 1970. Numerous sources report increased levels of shareholder activism, including increases in shareholder proposals. For instance The Investor Responsibility Research Center reported increases in shareholder activism in terms of shareholder proposals from 55 in 1986 to 294 in 1990 (Brancato & Gaughan, 1991). Anand (1997), in “Funds flexing muscles early in proxy battles”, reported that “in dozens of instances, companies agreed to make concessions to shareholders… Even top performing companies are no longer immune from shareholder activism…” From their comprehensive study of institutional and capital markets, Brancato and Gaughan conclude that:

...while [institutional investors] may be diverse, a high concentration of economic power resides among a relatively small and extraordinarily stable group of institutions. ... the very largest of these institutions, by virtue of their concentrated economic power, are increasingly in a position to exert substantial influence on the shape of corporate governance in this country (p. 1).

Indeed, it is so widely acknowledged that investment funds influence firms that empirical studies of fund influence examine patterns and effects, rather than the existence, of activity and influence. Gordon and Pound (1993) study, in part, various institutional shareholder voting alignments and found that the outcomes of shareholder sponsored proposals varied as a function of ownership by institutions and outside blockholders. They assert:

Previously the province of “gadfly” activists, governance proposals have become a tool used by a variety of large professional investors, including large fiduciary institutions... (p. 697).

Smith (1996) studies the effects of 51 shareholder activism programs by institutional investors from 1987 to 1993. Agrawal and Mandelker
(1992) examine “whether the monitoring activities of institutional investors, and their influence on the management of the firm, are related to the size of their investment in a corporation and/or the proportion of equity owned by them”. Using anti-takeover proposals, investment fund ownership, and abnormal return data from 1979 to 1985, their findings are consistent with an “active investor” hypothesis. Other studies, such as Brous and Kini (1994) provide evidence on the ability of investment funds to effectively monitor firms.

One line of investment fund research has explored fund activism and firm profitability. While these studies do not study fund influence per se, their design and analysis nonetheless provide evidence about fund influence. For example, in a study of corporate “refocusing” programs and firm profitability, Berger and Ofek (1997) found that about 39% of such programs were associated with a new outside blockholder or fund activism. In other profitability studies, Wahal (1996) and Opler and Sokobin (1996) document the occurrence and effects of fund influence in the management of nearly 200 firms.

In addition to the empirical and theoretical work, a plethora of cases are described in various investment-related publications that compellingly convey the influence exerted by funds over firms. Large pension funds that have defined and structured shareholder activism programs have been quite active (see Wahal, 1996). Calpers, which pioneered public pension fund activism and founded the Council of Institutional Investors in 1984, is highly visible in terms of such activities. The 1984 Texaco greenmail case involving that firm’s repurchase of the Bass brothers’ 9.9% stake for $1.3 billion (28% above market value) sparked a response from Calpers, which was one of Texaco’s largest shareholders. Dale Hanson, the CEO of Calpers and the founder of its shareholder activism program, asserts the importance of this case in the development of institutional activism.

By 1993, however, institutional activism was directly responsible for instigating reforms in the nation’s largest companies. It was pressure from institutional shareholders that led to the ousters of chief executives at General Motors, IBM, and American Express, each one a company in need of reform, each one a traditional bastion of managerial control. The news of the day was that corporate boards had to take more seriously the concerns of their institutional investors, who in turn found it more profitable, over the long run, to behave more like owners rather than mere holders of stock (p. 56).

4.5. The banks

Despite the legal separation of commercial and investment banking resulting from Glass–Steagall, writers such as Fitch and Oppenheimer (1970) present a theory of bank influence and control over corporations. Certainly, bank capacity to influence companies continues. Herman (1981, p. 130) shows that 66% of the largest 200 non-financial corporations and 76% of the largest 100 industrials had bankers on their board of directors in 1975. Baum and Stiles (1965, p. 30) show that 60% of all pension fund assets were managed by

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12 The results of these studies are mixed. Whether fund activism is effective in improving firm performance is, however, irrelevant to their ability to influence firms.

13 Most of these studies address the effect of fund activism on company performance and are premised on the assumption that funds can and do influence firms.
banks, while in 1972, just 71 bank trust depart-
m ents managed 72% of all trust assets (Herman
1975, p. 20). In addition, investment bank represen-
tatives sat on 42% of the largest 100 industrials’
boards of directors.

Specific evidence also demonstrates bank influ-
ence, although such activities tend to occur with
firms in financial trouble. Gogel (1977, p. 50)
asserts “the largest American corporations form
an interconnected network which is dominated by
financial institutions, especially commercial
banks...” Mintz and Schwartz (1985) cite bank
influence and control over 39 major US cor-
porations between 1977 and 1981 alone, exten-
sively recounting the details of banker
involvement with Braniff Airlines in 1979 and
1980 and International Harvester in 1981. They
conclude (Mintz, & Schwartz, 1985, p. 35) that
“capital shortages may result in the loss of
corporate autonomy and the transfer of control to
lenders”. Banker influence over companies is
reinforced by the huge dollar amount of pension
funds managed by banks as well as trust funds
controlled by banks. Of particular interest, Mintz
and Schwartz illustrate the continuing existence of
interlocking directorates involving managers of
leading financial institutions, including Morgan
Guarantee, one of the “House of Morgan” suc-
cessor firms.

4.6. A comparison

Previts and Bricker (1994) discuss the dangers of
applying contemporary thought to historical peri-
ods. Yet despite differences between the socio-
economic settings of the US in the 1990s and the
early 1900s, it is interesting to compare investment
managers of the 1990s with those of the Morgan
era. One important difference, the implications of
which we will return to later, relates to the prin-
cipal interests of the investment managers of the
two periods. The investment managers of the ear-
eri era were principally focussed on company
operations, and only secondarily interested in
share price and stockholder returns. In contrast,
modern investment managers are principally
interested in share price and returns, and secon-
darily interested in company operations. Thus, the
bankers of the early twentieth century often
wanted to act like owners (Morgan saw himself as
rationalizing chaotic industries and markets)
while contemporary investment managers gen-
erally do not.

Regardless of the management inclinations of
investment managers of the two periods, the mere
size of investment funds makes costless exit from
ownership firm shares difficult (Taylor, 1990).
Today funds are increasingly forced into being
“proprietors” rather than “punters”. While proxy
fights and shareholder proposals and resolutions
represent one of active control mechanisms that
can be exercised, a second that is receiving
increased attention and that again hearkens back
to the earlier period is the so-called “quiet influence”
exerted by investment funds involved in what many
have termed “relational investing” (see Hawley &
Williams 1996). In “Political voice, fiduciary acti-
ivism, and the institutional ownership of U.S. cor-
porations”, Hawley (1995) examines the shift of
ownership from predominantly individual to
institutional. He argues that pension funds, as
important institutional owners, will become,
increasingly, “relational investors”. To the extent
that this does not exist, the result is fund managers
that are less concerned with firms’ long-term
prospects or interested in the long term growth
and survival of firms. Rather, they may focus on
short-term operating results.

Overall, the modern investment fund manager is
remarkably similar to that of the Morgans of the
early period in two important respects. First, both
are important agents involved in aggregating and
allocating economic resources. Like the Morgans
of the past, investment funds aggregate the
resources of individual investors and are centers of
financial power having abilities to influence firms
and markets. Second, despite different inclinations
about doing so, both exert influence and control
over firms, and in this way, extend the realm of
their activities well beyond that described by
financial intermediation.

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14 Interested readers may wish to consult Soldofsky (1971)
for a description of investment fund holding of stock between
1930 and 1970.
5. An international perspective

The influence exerted by fund managers over US companies described in the preceding section is echoed internationally. Below, we briefly review studies of institutional influence and control in Germany, Japan, South Africa, and Canada. While these countries reflect patterns of investment quite different from that of the US (see Barr, Gerson & Kantor, 1995; Prowse 1995), they nonetheless illustrate the extensive influence of institutions over firms.

In Japan and Germany, corporate influence and control has traditionally been concentrated in the hands of financial institutions, much as it was in the United States prior to the 1920s, with individual investors generally playing a relatively insignificant role in capital markets. Walter (1993) asserts that “Japan’s industrial and financial communities have historically been interlinked more closely than in any other advanced economy.” Prior to the Second World War, banks monopolized the underwriting of corporate securities and through the institutionalized structure of the keiretsu exercised considerable influence over such firms. Despite US efforts after the war, this structure remains largely in place. Walter observes:

A unique form of corporate control has been integral to the Japanese model of industrial development... the focus was on continuous surveillance and monitoring of management performance by the managements of affiliated firms and bank...

In 1990, Japanese banks and other investment funds held about 40% of Japanese equity, with another 30% held by other operating firms (Porter, 1992, p. 42). German firms have similar associations with their bankers. Walter (1993) writes:

[The] Hausbank relationship has, as its basis, a business firm’s reliance on only one principal bank as its primary supplier of all forms of financing. The Hausbank, in turn, is deeply involved in its corporate client’s business... If the client firm faces collapse, the Hausbank may well convert its debt into equity and take control of the client...

In comparison with Japan and Germany, where control is exercised by banking institutions, a small number on holding firms owning shares in subsidiary operating firms dominates the South African stock exchange. Barr et al. (1995) find that “companies comprising the six largest groups on the JSE presently account for over 70% of the value of all the shares quoted on the exchange”.

In contrast to the preceding countries, the Canadian experience closely parallels that of the United States. In both, investment fund involvement in capital markets has increased to the point of comprising three-quarters of securities trading (Cohen, 1995). Increases in security ownership by investment funds has been accompanied by declines in direct, individual ownership (Andrews, 1991). In contrast to the US, activity by depository institutions has increased dramatically following relaxation of restrictions on bank ownership of securities (Johnson, 1994). As in the US, many writers have addressed the issue of corporate governance as it relates to institutional influence over firms (Montgomery, 1996; Yalden, 1996), and pension fund activism is promoted by trade groups such as the Pension Investment Association of Canada (Star, 1994). The extent of investment fund holdings in Canadian securities and the corresponding extent of Canadian individual holdings of investment funds motivated the Canadian Institute of Chartered Accountants to study the issue of fund reporting to investors and to issue Financial reporting by investment funds [Canadian Institute of Chartered Accountants (CICA), 1997].

The preceding literature strongly suggests the international character of institutional influence over companies. As Prowse (1995) argues, the differences in the specific forms of capital market relationships have resulted from differing legal and regulatory environments (neither Japan or Germany has Glass–Steagall type laws); yet remarkably, each of these countries reflect the important, and even dominant, role played by institutionalized capital. Indeed, Prowse concludes, “corporate governance systems based on the concentrated holding
of financial claims... may be more efficient means of resolving corporate agency problems..."
to the capital markets setting. Drawing on Coase (1937) and Berle and Means (1932), Jensen and Meckling’s (1976) agency view of the firm in a capital markets setting has been widely applied in both accounting and finance research. In theory, “the relationship of agency is one of the commonest codified modes of social interaction” (Ross, 1973). The Jensen and Meckling agency model portrays and analyzes an abstracted set of economic relationships, grounded in theories of economic organization, involving firm managers and investors. In accounting capital markets research (both empirical and analytical), agency models succinctly portray a single principal who is the owner and residual claimant, who hires another party, an agent, to manage the principal’s resources. In the corporate setting the principal is the “representative shareholder” who has entrusted wealth to the agent who is the “representative manager” [for example, in Baiman (1982) and Watts & Zimmerman (1986)]. When investment managers are incorporated in such structures, it is commonly in the form of a financial intermediary whose presence does not fundamentally alter the basic agency relationship between shareholder and firm manager (for example, Ramakrishnan & Thakor, 1984). Thus, the Berle and Means world of dispersed shareholder principals and manager agents has become the characteristic perspective from which to view capital markets agency relationships, while those involving investment funds (and other parties) are disregarded. To the extent that such a focus obscures the characteristics of capital markets agency relationships there is a value to incorporating investment funds in accounting contracting, reporting, and disclosure studies. In terms of the issues discussed in this paper — that is, the relationships among individual investors, investment managers, and operating firm managers — the traditional agency model typically depicts the following:

| Principal | Investor | Agent | Firm Manager |

This perspective relegates investment managers (among other parties) to the role of mere financial intermediaries. While it can also be criticized for failing to convey much of the richness of the capital market environment, it has the advantages of simplicity and strong parallels to Berle and Means; both focus on the relationship between investors and creditors.

Another aspect to this issue is that the identification of the parties to be included in a model inevitably has political implications, because the chosen parties’ interests and relationships are addressed to the exclusion of other parties. Thus the choice for simplicity and parsimony carries such implications, because restricting the model to investors and creditors excludes the consideration of other parties. Such exclusions are important, and unfortunate results can occur, such as the erroneous conflating, obscuring, or obliterating of significant financial reporting issues involving the excluded parties and their relationships.

6.3. Effects on financial reporting research and policy

As it turned out, the Berle and Means thesis and the simple, single-tier agency model that evolved from it carried financial accounting research and policy far from the condition of contemporary capital markets. Two elements fueled this result: federal regulation and the growth of investment funds as a vehicle for individual investors.

First, the passage of Glass–Steagall and the Investment Company Holding Acts effectively crippled the ability of investment funds to exert influence and control over operating firms. This substantially increased managerial control of firms from the 1940s through the 1970s. However, in recent years regulatory changes and federal revisiting of the role of investment funds in corporate governance have dramatically changed the landscape, as described in earlier sections of this paper. Second, the end of the twentieth century witnessed the phenomenal and unparalleled growth of investment funds (see Table 1). As individual investors increasingly place their financial assets in investment funds (see Table 2) their holdings in institutions is approaching 50% of household financial assets.

These three elements: the Berle and Means managerial control thesis and subsequent single-tier agency perspective of the capital markets, regulatory changes that increased the influence
and control ability of investment funds, and the substantial growth of investment funds, have led to a remarkable situation. The intellectual acceptance of the Berle and Means thesis and single-tier agency perspective has resulted in accounting and financial reporting research and policy that is focussed on corporation reporting to individual investors. The assumption of dispersed shareholders and the disregard of investment funds leads to research and policy that tends to overstate the power of managers with respect to owners. It correspondingly overstates the unobservability problem between managers and owners, and fails to fully recognize different agency relationship characteristics involving operating firms and investment funds. Second, the focus on the agency relationship involving operating firms and investors results in inattention to the separation of ownership from management problem as it relates to investors and investment funds, which has become relatively invisible both in policy and research.

The capital markets landscape implies many financial reporting priorities and issues beyond those implied by the simple, single-tier agency model. These implications are discussed in more detail below. But before addressing those, it is useful to reconsider the role of Agency Theory in studying capital markets relationships.

### 6.4. Expanding perspectives

While Agency theory is not the only perspective that can be employed to study relationships between parties, it provides a useful economic tool for portraying them. However, it does not seem intuitively appealing to necessarily restrict capital markets agency theory to the simple form principally used in contemporary research. Indeed, Agency Theory can be thought of from several perspectives. From the broadest perspective, it represents a conceptual way of describing relationships between two or more parties. In terms of the way that it is used in modern empirical, archival capital markets research and related analytical work, it is typically restricted (à la Jensen and Meckling) to two parties, investors and managers, ostensibly to make the model tractable to mathematical analysis. While typical in accounting research, neither this sort of mathematical simplification nor traditional empirical archival methods are necessary; economic studies such as DeLong (1991), for example, use agency-type models in conjunction with historical methods. Writers such as Blair (1995, pp. 31, 47) have presented elaborations of the “Basic Berle–Means Model” to more fully portray investment fund activities in capital markets; however such elaborations have not yet been explicitly applied to accounting and financial reporting. If capital markets agency theory is not thought of as a way to present a highly stylized and simplified relationship between investors and managers, but instead as a way of identifying and portraying relationships among two or more parties in the capital markets setting, then the agency modeling goal becomes to portray these parties (as parsimoniously as possible) and their relationships. Many such relationships exist, and studies need not identify and portray them all, but neither do they need to be restricted to investors and managers. Instead, studies need to portray those parties and relationships that are pertinent to their own focus.

Because our paper focuses on the role of investment funds with respect to operating firm managers and investors, a possible alternative structure might be portrayed as:

<table>
<thead>
<tr>
<th>Principal</th>
<th>Agent — Principal</th>
<th>Agent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
<td>Investment</td>
<td>Firm</td>
</tr>
<tr>
<td></td>
<td>Manager</td>
<td>Manager</td>
</tr>
</tbody>
</table>

#### Table 2

Household holdings in investment funds (% of total household financial assets)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance companies</td>
<td>7.4</td>
<td>7.4</td>
<td>7.8</td>
<td>8.4</td>
<td>8.5</td>
<td>8.5</td>
</tr>
<tr>
<td>Muta funds</td>
<td>6.3</td>
<td>6.6</td>
<td>7.0</td>
<td>8.1</td>
<td>8.7</td>
<td>8.7</td>
</tr>
<tr>
<td>Pension funds</td>
<td>18.0</td>
<td>18.2</td>
<td>19.1</td>
<td>19.6</td>
<td>20.2</td>
<td>20.2</td>
</tr>
<tr>
<td>Other institutionsb</td>
<td>6.2</td>
<td>6.8</td>
<td>7.1</td>
<td>7.1</td>
<td>7.9</td>
<td>7.9</td>
</tr>
<tr>
<td>Total</td>
<td>37.9</td>
<td>39.0</td>
<td>41.0</td>
<td>43.3</td>
<td>43.2</td>
<td>45.3</td>
</tr>
</tbody>
</table>

a Constructed from OECD data (OECD, 1997).

b “Other institutions” include bank trusts, finance companies, real estate investment trusts, and security brokers and dealers.
This formulation retains the concept of principals and agents. In it, investors, as principals, aggregate resources in an investment fund. Their agent, the investment manager, invests these resources in firms and has an agency relationship with firm managers. Investors are defined more broadly, and are comprised not only of mutual fund owners, but holders of insurance policies with cash values, investors in money market funds, pension fund participants, and financial institution depositors, among others. As Berle and Means emphasize, it is where ownership dispersion occurs that influence and control is lost. From this perspective contracting and financial reporting/disclosure issues occur at two levels and vary depending upon the nature of ownership concentration/dispersion.

7. Financial reporting implications

7.1. Overview

This two-tier structure has financial reporting implications of two sorts. First, it leads to financial reporting issues in terms of firm reporting to investment funds (and investors), investment fund reporting to investors, and firm reporting through investment funds to investors. Whereas historically accounting research, the accounting profession, and financial reporting standard setters have concentrated on firm reporting to investors, the volume of investment activity that occurs via institutional processes implies a need for greater attention to these additional issues. Some recent work, such as the Jenkins Committee Report [American Institute of Certified Public Accountants (AICPA), 1994], which proposes a “Business Reporting” model based largely on studies of information uses and needs of professional investors, seemingly reflects a greater awareness of these issues.

Second, and more broadly, our findings suggest that the single-tier agency relationship commonly used as the basis of financial research and policy tends to obscure the information and financial reporting needs of many types of claimholders (see Bricker & Previtts, 1999). That multiple agency relationships exist in capital markets settings is already widely accepted. It is well understood that capital markets are (and have been) characterized by complex and dynamic structures of relationships that have evolved in changing political, social, regulatory, and economic environments. Their complexity has been portrayed by historical work such as McCraw (1984). However, while accounting and economic research recognizes the existence of multi-tier agency relationships in theory (Antle, 1982), the simple, abstracted manager–shareholder structure remains a principal foundation for accounting research and financial reporting considerations, both at academic and policy levels. This is useful for considering many issues and promotes analytical computational efficiencies, yet also may result in some of the problems described above. A broadened perspective on formulating agency models and the application of more diverse research methods in conducting accounting research may result in better portrayals of capital markets relationships and richer understandings of financial reporting issues. Below we focus on financial reporting implications related to the two-tier structure proposed in the following areas:

• differential reporting, effects of institutional ownership on information about firms,
• managers’ choice of accounting methods, investment managers’ reporting to investors, investors’ assessment of fund risk, and conflicts of interest,
• insider-type trading activities related to investment managers and investors, and
• reporting to claimholders generally

7.2. Differential reporting

An extensive body of research (including Kim, 1997; Lev, 1988) suggests the importance of considering investor classes in regards to firm reporting. The two-tier structure suggests that investment funds, because of their size, can ameliorate the observability problem commonly associated with an agency structure involving dispersed owners, and helps focus on differential information needs of investment funds and noninstitutional investors as different investor classes. Investment fund size makes monitoring and information gathering economically practical, and the size and influence of the fund’s holding of a firm’s shares makes firm managers more willing to communicate directly with fund managers.

Theoretical and empirical evidence supports treating noninstitutional investors and investment funds as different investor classes. Shleifer and Vishny’s (1986) “Large Shareholders and Corporate Control” shows how agency monitoring problems are affected by the existence of large shareholders, and how large shareholders are able to monitor firms and influence firm policy. Kim (1997) shows that institutional ownership affects price and volume responses to earnings. Other studies have shown that investment funds anticipate earnings surprise and trade accordingly, ahead of the announcement. Fund flows suggest that this trading occurs with smaller investors (Ali & Durtschi, 1997). Overall, this evidence with our characterization of investment funds and noninstitutional investors as separate classes of investors with different information needs, and modeling them as such helps refine research questions about the financial reporting needs related to these separate classes of investors.

7.3. Information effects of investment fund ownership of securities on individual investors

Furthermore, the proportion of securities owned by investment funds may affect information available to individual investors about firms, particularly when such investors rely upon financial analysts for information about firms. Financial analyst coverage of firms is inversely related to proportion of institutional ownership (Grant & Rogers, 1998), when controlling for firm size. Firms with higher levels of institutional ownership may generate less information for individual investors. Porter’s (1992) finding that firms with high institutional ownership proportions had larger abnormal returns on earnings announcement dates is consistent with this conjecture. The two-tier structure provides a basis for rationalizing differential firm reporting to investors depending upon the ownership structure of the firm.

7.4. Firm managers’ accounting and economic choices

The two-tier structure affects interpretations involving the filtering of information from firms to investment funds to individual investors and, possibly operating firm accounting and economic choices. Myopic managerial choices have been studied extensively in business research, and it has been conjectured that institutional ownership of companies may aggravate this tendency (for example, see Laderman, 1992).

The two-tier structure provides a perspective for understanding the possible incentives. Investment manager compensation depends, to a large extent, on fund size, which in turn is driven by investor assessment of past fund performance and their formation of expectations regarding future fund performance. Mutual funds invest in large numbers of operating firms. The filtering of information that occurs when operating firms report to investment funds which in turn report to individual investors may lead investors to evaluate funds on the basis of relatively simpler, short-term aggregate measures, such as annual returns. Then an increased focus on short-term earnings maximizing decisions may be reflected in investment
managers’ accounting choices and economic resource allocation (investing) choices. That such filtering occurs is suggested by the numerous ranking and rating reports of fund performance that appear regularly in popular business publications. Operating firm managers’ compensation is often partially a function of the firm’s cost of capital. If this cost is affected by investment managers’ investing choices, then firm managers’ accounting and economic choices may correspondingly focus on maximization of short-term firm profitability. For example, investment managers may choose income increasing accounting methods in valuing certain restricted and Section 144a securities which are not market-determinable, choose to invest in firms with high short-term earnings prospects, and make economic choices about asset disposals so as to maximize compensation (Chandar, 1997). On the other hand, if investors focus on multi-year, instead of most-recent year investment fund results, then the opposite may occur. Investment fund monitoring and influence of firms would then lead to accounting and economic choices maximizing long-term profitability (see Hansen, 1991; Kochhar, 1996).

7.5. Fund reporting to investors

Traditionally financial reporting focuses on the relationship and reporting between operating firms and investors, and there is consequently little published work assessing the adequacy of investment fund reporting to investors for facilitating mutual-fund and pension-fund resource allocation decisions. Only recently, for example CICA’s (1997) Financial reporting by investment funds, have serious attempts been made to address investment fund reporting issues. The two-tier structure proposed here facilitates study of fund reporting to investors as conceptually distinct from firm reporting to investors or firm reporting to investment funds.

The failure to focus on fund reporting to investors has had several results. It is known that investment fund reporting is less comprehensive than firm reporting, although this situation is certainly ameliorated by services such as Morningstar and the many financial press publications which analyze and rate various mutual funds. Reviews of the financial reports of investment funds suggests that information is provided by funds on a less timely basis and with far greater variability in disclosure content than is found in corporate reporting (Chandar, 1997; Henriques, 1994c). For example, disclosure related to investment asset cost, transaction profitability, fund risk, and the valuation of some securities vary widely. Some of these differences are merely in amount while others reflect apparently different methods. It is not clear whether fund reporting enables investors to compare funds. Funds file financial information semiannually, revealing only snapshots of their investment holdings. Unlike corporations, funds are not required to file supplemental disclosures even when significant events occur that could change an investor’s perception of the risk of the investment. For example if the investment manager is replaced, or if new investment strategies with significantly different risk profiles are initiated (as discussed in more detail below). Some funds include their portfolios in their prospectuses; others include them in statements of additional information that must be ordered separately. The dearth of information encourages investors to make investment decisions based on information obtained at the point of sale, often from funds’ sales staff, or from brokers. Many investors also rely on fund ratings and rankings provided by publications of varying quality in making fund investment choices.

7.6. Investor assessment of fund risk

The single-tier structure implies an importance to consideration of operating firm risk. In contrast, the two-tier structure implies an importance to assessing both operating firm and investment fund risk, another matter addressed in the CICA (1997) report. However, fund reports contain very little information about risk.

Investment managers’ compensation contracts provide them with incentives that may similarly affect their choices regarding investment portfolio risk. They face intense competitive pressures to achieve at-or-above benchmark returns, which may motivate them to make risky investments, for
example in derivatives, in order to outperform competitors. This motivation results from their incentivized compensation contracts, which reward them according to measures of fund return achieved, and the low observability of a fund’s level of risk. Even relatively conservative funds face this problem. McGough (1994) asserts that “managers’ desire to win incentive pay is a major reason that the worst damage to mutual funds from derivatives is falling on the most conservative types — money market and bond funds. In these funds, the competition is toughest, because their investments are so similar.” While it has been illegal for individual investment advisers dealing with small clients to base pay on performance, mutual funds are exempt from that statute, even though most mutual fund holders are individual investors.

The difficulty in assessing fund risk can be illustrated by considering the impact of derivatives, which are not commonly described in fund reports. Contracts like interest-rate options and foreign currency contracts are not only used to hedge against risk, but also to increase risk. Apart from derivatives, funds may engage in transactions such as short selling, margin purchasing, and investing in other exotic financial instruments. SEC commissioner Richard Roberts [quoted by McGough (1994) in the Wall Street Journal] asserts that stock and bond mutual funds “should be able to invest in whatever they want to, with the caveat that the risk of those investments should be fairly and fully disclosed to investors”. However, the issue of what constitutes fair and full disclosure of risk by funds has not been fully studied. It is not known whether investors can distinguish among funds on the basis of risk.

7.7. Conflicts of interest and insider-type trading

While the historic focus on company reporting to investors has highlighted operating firm conflict-of-interest and insider trading abuses, researchers or policy makers have not carefully studied such activities involving investment managers. It is known that investment managers can engage in business dealings with parties in whose firms funds have invested. For example, Henriques (1994a) has identified cases in which investment managers, with little regulatory oversight, invest in firms that employ executives, advisers, or underwriters with whom they have close ties. The financial and popular press reports cases of high profile investment managers who have purchased stock that enriched a family member. Henriques (1994a) identifies instances of investment managers investing privately in deals promoted by a broker from whom they had bought stocks for their funds. The risk that investment managers have a close relationship with their investees is comparable with a similar allegation in the case of its precursor, the publicly traded investment trust, earlier this century.

Some of the funds promising the highest growth rates invest in start-up firms in the US or in loosely regulated markets abroad. They also invest in small firms or purchase penny stocks, in their attempts to beat competitor and benchmark returns. These are markets that are typically thinly traded and followed, and reliable information is often scarce. Portfolio managers therefore rely on “professional ‘stock boosters,’ aggressive brokers and firm insiders — whose chief goals are to sell stock, collect fees, or increase the value of the shares they already own” (Henriques, 1994b). The operating firm benefits from this “stamp of credibility” that is afforded to it by an investment by a large mutual fund, and the investment managers in turn anticipate prospects of considerable gains. Particularly in thinly traded markets, the very act of sale by a mutual fund may influence market prices, making it difficult to determine fair market prices for fund assets.

Some of these transactions are simply illegal, as the Investment Company Act of 1940 prohibits investment managers from purchasing stocks publicly underwritten by, or formally affiliated with, their firms. Others, while not violations of law, are of obvious and legitimate interest to fund investors, and have clear reporting implications that correspond to similar disclosure requirements for operating firm managers. Certainly, the apparent low visibility of these transactions and relationships leads to research questions as to fund investor reactions should such information be readily available.
7.8. Other claimholders

Just as focusing on investors and company managers obscures both the nature of the financial reporting “problem” and implications with respect to investors, fund managers, and company managers, so also the single-tier agency model obscures financial reporting issues involving other kinds of claimholders, including customers, employees, and communities. In this way, the single-tier model has political implications as it removes the interests of other parties from consideration. Each of these parties has information rights of the sort commonly associated with shareholding (ownership). As Bricker and Previts (1999) write, ownership investment carries with it implicit contracts (as opposed to the explicit contracts of agency theory), among them being the right to know about that which is owned — that is, an information right. They argue further that the “investments” made by other parties, such as employees, the community, and other parties (including their investment from bearing the cost of company operations, such as pollution) give these parties a similar claim in the company, and a corresponding information right. From this perspective, the agency or other structural relationships among parties are not limited to those who are shareholders, and there are certain property rights, and consequently information rights, accruing to these other classes of claimholders. As previously discussed, Berle and Means apparently held the view companies should be held responsible to broader constituencies, and argued that company’s board of directors should have trusteeship responsibilities to these parties. More flexible agency models can facilitate portraying and studying such models and their implications, as we do with respect to investment fund managers using a two-tier model.

The different goals of investment fund managers today also have implications for reporting to other classes of claimholders. As previously discussed, a principal goal of the Morgans of the earlier era were operational — they sought to achieve economic goals that, secondarily, affected firm share value. In contrast, investment fund managers of today are principally concerned with share value and returns, and despite the influence they exert over operating firms, only secondarily (and reluctantly) focused on firm economic goals and operating activities. It is the cost “punting” that makes them act as proprietors. In contrast, other claimholders have far more interest in firm operating activities, and these interests can be addressed by broadened reporting to address them.

8. Concluding comments

In this paper, using the historical record from two time periods, we identified influence and control relationships involving investors, investment funds, and firms beyond those addressed by Berle and Means, and showed that investment managers have important influence and control capabilities beyond financial intermediation. Brief considerations of Germany, Japan, South Africa, and Canada suggested that similar roles are played by investment funds, including banks and other institutions, in those countries. Overall, the evidence suggests the importance of investment funds in influencing and controlling firms, across time and countries. To more fully portray these observed relationships among investors, investment funds, and firms we presented a two-tier capital markets structure interposing investment managers as agents of investors and principals of firm managers. This structure more clearly separates and illuminates the contracting and financial reporting issues involving these parties, particularly in terms of firm reporting to investment funds, and fund reporting to investors. Particularly, in conjunction with our historical analysis, it highlights a hierarchy of investing relationships in which the dispersion or concentration of ownership interests may vary. While Berle and Means point to the dispersion of ownership interests with respect to firm managers, the evidence suggests that the dispersion of individual ownership interests with respect to investment funds may also be an important issue to consider.

We do not want the reader to conclude that our principal argument is for replacing the single-tier agency model with a two-tier one to study capital markets, per se. Instead, our point is that in trying to portray and study capital markets parties and relationships from an agency perspective,
researchers should balance model parsimony with descriptiveness. For the purposes of this paper, a two-tier model is useful. Investment funds are an important type of participant in US and international capital markets, and incorporating them improves our view of financial reporting issues.

From a broader perspective, we conclude that models of capital markets relationships should be contingent on the issue under study. To more fully understand the accounting and financial reporting issues of contemporary capital markets, it is important to portray the significant parties and relationships. While richer models may render them less tractable to mathematical analysis, they may offer fruitful areas of application for historical and field research methods, as well as archival empirical research.

Understanding the structure of influence and control relationships in modern capital markets is both useful and timely. The recent activities of the AICPA, FASB, and CICA suggest the importance of a theoretical structure from which financial reporting implications can be derived for investors in mutual funds as well as direct shareholding investors. Traditional financial reporting policy has focused on the latter of these, leaving fund reporting issues and those of reporting to other claimholders largely unaddressed. Our results imply that financial reporting research and policy issues should be reconsidered in light of this two-tier setting specifically, and in terms of a broader set of claimholders, more generally. Such considerations may provide a basis for improving financial reporting both in process and in product.

References


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