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The Demise of the Professional Partnership?
The emergence and diffusion of publicly-traded professional service firms

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Abstract

Organization theorists typically explain the *professional partnership* as an optimal governance structure under conditions of extreme human capital-intensity. However, the emergence of *publicly-traded corporations* in some professional services seems to challenge this assumption. Using a range of primary and secondary sources, this paper documents and analyzes the history of the public corporation since 1960 across five professional services—law, accounting, advertising, investment banking, and management consulting—to assess the implications for our understanding of professional partnerships. It argues that the long dominance of the professional partnership is more an artifact of professional codes of ethics—specifically, prohibitions on outside owners—than an optimal adaptation to human capital intensity. The analysis challenges existing theories of the professional partnership and suggests caution in holding them out as models for knowledge-intensive firms in general.

It is commonly asserted that human capital is becoming an increasingly important source of value throughout the economy and that this has important implications for how firms are organized and governed. In particular, this trend is often thought to imply that the human capitalists—i.e., employees—will play an increasingly large role in ownership and governance (Blair & Kochan, 2000; Rajan & Zingales, 2000; Teece, 2003). To understand these implications, scholars are increasingly looking at the organization of professional service firms (PSFs), which rely almost purely on human capital, for lessons on how to organize knowledge-intensive firms more broadly (Blair & Kochan, 2000; Ghoshal & Bartlett, 1999; Greenwood, Li, Prakash, & Deephouse, 2005; Lowendahl, 2000; Scott, 1998; Teece, 2003).

One of the central "stylized facts" about PSFs is that they are organized as *professional partnerships*, which are characterized by several distinctive governance features. One of the quintessential features is "employee ownership." More specifically, the professional partnership features the absence of any outside ownership: the firm is owned exclusively by the professionals that work inside the firm. For example, even the largest law firms and public accounting firms, with thousands of employees across multiple continents, are owned solely by partners inside the firm.

The prevalence of the professional partnership among PSFs has led organizational theorists to infer that this organizational model is particularly efficient for the economic environment facing PSFs and a growing theoretical literature seeks to explain how, and under what conditions, the professional partnership generates superior incentives for attracting, investing in, or motivating effort from human capital (Alchian & Demsetz, 1972; Dow & Putterman, 2000; Fama & Jensen, 1983; Greenwood & Empson, 2003; Hansmann, 1996; Jensen & Meckling, 1979; Levin & Tadelis, 2005; Morrison & Wilhelm, 2003, 2004; Roberts & Van den Steen, 2000).

However, an important but often overlooked issue regarding the professional partnership is that law firms and public accounting firms are *prohibited* from having outside owners. Regulations established by their professional associations prohibit non-professionals from owning stakes in law and accounting firms. This makes it problematic to interpret the persistence of the professional partnership in law and accounting as an indication of its efficiency or optimality, since it results from constraint rather than choice.

Furthermore, as Table 1 indicates, in several professional service industries,[1] some firms have transformed into publicly-traded corporations. Because public ownership by definition violates the ownership model of the professional partnership, these firms, too, challenge the functional assumption that the economic conditions facing PSFs make the features of the professional partnership optimal.

On the other hand, Table 1 also indicates that some large PSFs have *not* chosen public ownership (including the large strategy consultancies such as McKinsey, BCG and Booz Allen Hamilton). And some large ad agencies (e.g., Young & Rubicam) and investment banks (e.g., Goldman Sachs) only very recently transformed to public ownership. Thus, not all PSFs *allowed* to go public have chosen to do so, perhaps indicating that there *is* some economic advantage to the exclusion of outside owners under specific conditions.

This paper takes a closer look at the history of the public corporation in several professional services to understand what its emergence says about the nature of the

[1] The boundaries of the "professional services" are not tightly defined. Frequently included are accounting, law, management consulting and investment banking; and advertising, engineering, and architecture are also often included. The definition does not coincide with the traditional "professions," as medicine is sometimes not included while consultants and investment bankers are. A more accurate label might be "business advisory services" (Lowendahl, 2000).

professional partnership. Is it indeed superior to the public corporation under certain conditions? Or is it a constraint—an artifact of professional regulations? Answering this question entails assessing the extent to which the distribution of public ownership—across industries, and over time and across firms within industries—is consistent with the predictions of theories of the professional partnership.

The paper documents and compares the incidence of public ownership since 1960 in the U.S. in five professional services: law, accounting, advertising, investment banking, and management consulting. The analysis is based on a broad range of primary and secondary sources. The primary sources include interviews with industry participants and documents from professional associations and the secondary sources include industry trade publications, industry histories, and academic analyses.

The main argument drawn from the historical analysis is that the traditional absence of public ownership stems more from professional norms than the existence of unfavorable economic conditions. It turns out that at one time, all five of the industries studied had prohibitions against outside ownership, as one manifestation of a larger professional code of ethics. Once these prohibitions were repealed, because of firms' demands for outside capital either to invest or simply to cash out their owners, many of the larger and more capital-intensive PSFs eventually went public. Furthermore, there is little evidence that the ownership model of the partnership is advantaged vis-à-vis public ownership even where capital is of low value (i.e., under conditions assumed optimal for the professional partnership), except perhaps for smaller firms. Overall this analysis challenges the common assumption that the professional partnership is an optimal adaptation to conditions of high human capital intensity; and thereby suggests caution to scholars who seek to hold out PSFs as exemplars for knowledge-intensive and human capital-intensive firms more broadly.

The next section discusses the literatures on the professional partnership and on public ownership to identify factors that might explain the historical patterns of ownership across the five industries. The next five sections discuss the existence, distribution, and relative performance (where relevant) of public corporations in each of the five industries. The Discussion section summarizes patterns across the industries and concludes with implications for existing theory and future research.

THEORETICAL BACKGROUND: OWNERSHIP, PROFESSIONAL PARTERSHIPS, AND OPTIMAL INCENTIVES

There tends to be confusion around what the term *professional partnership* specifically means, so it is useful to begin with some clarifications. In the organizational literature, the term partnership is often used differently than in a legal context. From a legal standpoint, a partnership is a particular organizational form which, in contrast to the corporation, lacks standing as a separate legal entity and is taxed differently (Roberts, 2004). Partnerships, in this sense, are widely employed in many industries, but are usually relatively small organizations. Historically, many PSFs were partnerships in the legal sense, which accounts for the use of the term in the organizational literature. However, more and more PSFs, including law and accounting firms, are no longer partnerships, having been converted into various forms of private corporations for tax and liability purposes (Lorsch & Tierney, 2002). By contrast, in the organizational literature, the *professional* partnership (which is often referred to simply as a partnership) refers to a distinctive set of governance characteristics, independent of any underlying legal form (Empson & Chapman, 2006; Greenwood & Empson, 2003; Greenwood, Hinings, & Brown, 1990; Lorsch & Tierney, 2002). Hereafter, this paper will use the term "partnership" to mean an archetypal professional partnership.

It is important to note that the archetypal professional partnership comprises not one but several distinctive characteristics. A review of the literature identifies several, including (1) ownership held exclusively by professionals who work for the firm[2]; (2) highly dispersed authority, manifested, for example, in broad participation by professionals in strategic decisions; rotating executive positions; and/or individual autonomy in the production process; (3) an up-or-out promotion system; and/or (4) a strong spirit of teamwork and collegiality, stemming from both formal practices and informal norms (Eccles & Crane, 1988; Empson & Chapman, 2006; Gilson & Mnookin, 1985; Greenwood et al., 1990; Lorsch & Tierney, 2002; Maister, 1993).

The common tendency in the literature is to contrast the professional partnership with the public corporation. But the multiplicity of defining features makes it problematic to assume that public ownership is *per se* incompatible with the professional partnership. By definition, the public corporation has outside owners and thus violates the first characteristic (no outside ownership). But the other features of the professional partnership model—the internal features—are not necessarily incompatible with public ownership, at least by definition. One could imagine, for example, a public corporation that distributed shares widely among employees and fostered a collegial, team-oriented culture and thus still satisfied some definitions of the professional partnership. Whether these internal features are, for some reason, incompatible with public ownership is an important but open question (revisited in the Discussion).

For this reason, theories which hinge on internal features of the partnership, such as employee voting (Hansmann, 1996) or equal distributions of profits(Gilson & Mnookin,

[2] In other words, no equity investors who contribute *only* capital. Technically, many professional partnerships have “outside” owners in the form of retired partners who retain equity stakes. But these owners are clearly distinct from investors who have no other relationship with the firm.

1985; Levin & Tadelis, 2005) are not directly relevant to the issue of public ownership. Instead, the relevant functional theories are those that focus on the costs and benefits of outside owners.[3] As such, the issue of public PSFs could be seen as a special application of the larger corporate finance literature on public vs. private ownership.

In the corporate finance literature, the most commonly theorized benefit of public ownership is improved access to capital (Dow & Putterman, 2000; Pagano, Panetta, & Zingales, 1998; Ritter & Welch, 2002). A second frequently posited benefit is an increase in the liquidity of the firm's shares, which increases their value and allows owners to diversify or cash out more easily (Pagano et al., 1998; Ritter & Welch, 2002).

The primary theoretical cost of public ownership is an increase in agency costs. Insiders' effort should decrease because their share of profits decreases as some of the ownership is sold to investors—and because a more dispersed base of outside owners monitors less (Mikkelson, Partch, & Shah, 1997; Pagano et al., 1998; Ritter & Welch, 2002). In addition, public ownership imposes some fixed administrative costs, including one-time costs of arranging the IPO and on-going costs associated with public disclosure requirements (Pagano et al., 1998).[4]

Moving to the professional services environment, theories about the ownership model of the professional partnership essentially argue that the financing benefits of public ownership are diluted while the costs, in terms of lost incentives for human capital, are

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[3] Note also that this analysis skips over an intermediate form: a private firm *with* outside owners. However, the private firm with outside owners, like the public corporation, is uncommon among PSFs—for reasons which will become clear in later sections of the paper.

[4] It is interesting to note that there is very limited empirical research comparing public and private firms, primarily because of the difficulty of acquiring data on private firms (Chemmanur & Fulghieri, 1999; Pagano et al., 1998; Ritter & Welch, 2002). However, what little evidence there is lends some support to these assumptions. Pagano et al (1998) and Kwan (2002) compare public and private firms in settings where regulatory requirements produce financial data on private firms and find that public firms have lower profitability. Mikkelson, Partch and Shah (1997) find a decline in profitability after firms go public. These studies generally infer that firms suffer from increased agency costs after going public. Pagano et al (1998) also find evidence that firms experience greater access to capital after going public.

greatly exacerbated. In this literature, the key characteristics of PSFs are an almost exclusive reliance on skilled, non-firm-specific human capital and a limited ability to monitor the efforts of or evaluate the outputs of that human capital (Alchian & Demsetz, 1972; Dow & Putterman, 2000; Fama & Jensen, 1983; Jensen & Meckling, 1979; Levin & Tadelis, 2005; Roberts & Van den Steen, 2000). Thus, on the one hand, access to capital is assumed to be of distinctly low value for PSFs as their investment needs are minimal. PSFs are typically assumed to exhibit few scale economies, their physical assets (e.g., office space, computers) are generic rather than firm-specific and thus amenable to leasing or debt-financing (rather than equity financing) (Dow & Putterman, 2000; Hansmann, 1996), and R&D and advertising investments are minimal.

On the other hand, the agency costs are assumed to be very high. Insider incentives are particularly critical, because attracting and motivating skilled professionals is very valuable yet also poses considerable contracting difficulties. In fact, several classic articles on the economic theory of the firm explicitly explain the ownership model of professional partnerships by asserting that professional labor is extremely hard for outsiders to monitor and thus ownership is most optimally allocated only to insiders to maximize effort (Alchian & Demsetz, 1972; Fama & Jensen, 1983; Jensen & Meckling, 1979).

But theories about the ownership model of professional partnerships go beyond agency cost arguments and rely on other supposedly distinctive aspects of PSFs. For example, both economic and sociological theorists argue that a strong culture that fosters cooperation and intrinsic motivation is a key source of advantage for PSFs, because professionals' portable skills render formal authority and traditional incentive systems less effective (Eccles & Crane, 1988; Gilson & Mnookin, 1985; Greenwood & Empson, 2003; Lorsch & Tierney, 2002; Maister, 1993; Teece, 2003). But public ownership may weaken a firm's culture in several ways. Public disclosure and other shareholder protections may require the adoption of more formal processes and hierarchical structures (Marchisio & Ravasi, 2001), which could conflict with some of the internal features of the professional partnership model mentioned earlier, such as highly dispersed authority and a strong collegial culture (Greenwood & Empson, 2003). And making the firm's shares freely available may reduce the prestige of an ownership stake, thereby diminishing the "lure of partnership" (Greenwood & Empson, 2003; Greenwood et al., 2005; Groysberg, Matthews, Nanda, & Salter, 1999; Krause, 1963). Finally, Morrison & Wilhelm (Morrison & Wilhelm, 2003, 2004) hypothesize that the illiquidity of the shares in a professional partnership makes partners care about the firm's future reputation and thus induces them to transfer their tacit human capital to junior professionals via mentoring. In their model, the liquidity of public ownership would lead partners to forego efforts at mentoring, yielding lower levels of human capital. Regardless of the specific mechanism, the core assumption is that the professional partnership will have better and/or more motivated human capital than public corporations.

These theories, then, suggest that the professional partnership will be more prevalent the more that human capital is both valuable to the production process and difficult to contract for. Conversely, as *non*-human capital becomes a more valuable input (and/or as human capital becomes easier to contract for), we might expect to see public corporations. Capital will be more important where production is more capital intensive. Human capital incentives will be less important the more that the production process is standardized(Greenwood & Empson, 2003; Morrison & Wilhelm, 2004). And capital will be more important and the incentive effects of the partnership will decrease as firms get larger.[5] Therefore in the following industry histories, we will pay attention to the factors of firm size and the extent to which production is capital intensive and/or standardized.

INDUSTRY HISTORIES

As noted in footnote 1, there are no hard and fast boundaries of "professional services". This analysis covers five industries that are commonly studied within the rubric of professional services: law, accounting, advertising, investment banking and management consulting. Four of these (advertising excluded) are well-known for featuring professional partnerships. Two retain prohibitions against public ownership, three do not. More complete coverage—or perhaps profitable future extensions—would include engineering, architecture, and medicine (physician's practices, not hospitals). [6]

Also, this study focuses on the U.S. (and U.S.-based firms), for purposes of data availability. To a large degree, the trends in the U.S. industries have proceeded ahead of or in parallel to developments in other nations and thus the patterns identified here may well be relevant in other national settings. Of course, there are important exceptions.[7] Some of these will be noted in the text, while others will be left to future research.

The following five sections cover roughly the same issues in each industry, where applicable. They start from Table 1, discussing the extent of public ownership in 2003 and

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[5] A size/ownership relationship is consistent with the limited empirical evidence. Pagano, et al. (1998) find that larger firms in their sample were more likely to go public. And Mikkelson, et al. (1997) find that for the first five years after going public, smaller firms performed worse than their peers while larger ones did not.

[6] Perhaps the most systematic approach would be to analyze all the sub-sectors of NAICS sector 54 (Professional, Scientific & Technical Services), since they likely share many of the economic characteristics which are presumed suited to the professional partnership. That is, however, far beyond the scope of a single article which is based on fine-grained historical detail.

[7] For example, the very existence of the U.S. investment banking industry, as separate from the commercial banking industry, is distinctive. In most countries, universal banks provide both commercial and investment banking services, whereas the Glass-Steagall Act of 1933 forced their separation in the US. Thus, the ownership patterns in investment banking may be quite different outside of the US.

1960. Then they discuss the existence and rationale for any prohibitions on ownership forms as well as any movements to repeal such prohibitions. To the extent that such prohibitions were removed, the sections then cover (a) the industry conditions around the first emergence of public ownership as well as firms' rationales for going public; (b) the pattern of adoption of public ownership across firms over time, focusing on differences in the types of firms that adopted at different times; and in some cases, (c) more in-depth stories of specific high-profile firms (Goldman Sachs, McKinsey, and Booz Allen & Hamilton). Finally, each section summarizes the implications of the industry's particular experience.

Law

Around the world, law firms are prohibited from going public by the professional associations (e.g., bar associations) that regulate the practice of law.[8] In the US, the specific prohibition is that firms that sell legal services (legal advice and representation) are not permitted to have non-lawyer owners. This effectively prohibits public ownership, which would make a law firm's ownership available to anyone.

The rationale behind this ownership restriction is the prevention of conflicts of interest, and as such, it is one manifestation, along with many other regulations, of the legal profession's code of ethics. The basic concern with outside ownership is that it could divide a lawyer's loyalty between serving the interests of clients and those of shareholders. As one member of the American Bar Association put it: "allowing non-lawyers, who would presumably only be concerned with the bottom line, to invest in law firms would

[8] There is no supra-national regulation that covers all law firms. Rather, regulatory prohibitions, based on professional codes of conduct, tend to be similar in all jurisdictions. Both civil and common law systems have ownership prohibitions.

compromise lawyers' ethical and professional obligations" to protect clients' interests above all others (Garamfalvi, 2006; Sherwood, 2004).[9]

While this prohibition is the proximate cause for the absence of public ownership in law, it is not a complete explanation, since the persistence of the prohibition is ultimately endogenous—subject to repeal by the professionals themselves. As Gilson and Mnookin (1985) noted, calling attention to the ownership rules merely "shifts the inquiry to explaining why the prohibition continues in light of the influence of lawyers on the relevant legislation. … If there is no economic reason for the absence of publicly held law firms—if the explanation proves to be historical and cultural—then the future may yet hold some surprises."

The persistence of this ownership prohibition in Law might in part be attributable to the relatively small size of law firms in general. While the legal industry itself generally marvels at the size of its largest firms at any given historical moment, its largest firms are quite small relative to most industries and even compared to other professional services (as Table 2 indicates). The relatively small size of law firms, in turn, is partly due to the strong and local nature of the regulation of law firms. In the US, for example, the practice of law is regulated at the state level, which has made cross-state combinations of law firms troublesome (though certainly not impossible)—and the same applies for cross-country combinations. The absence of large firms, for whom the benefits of public ownership might outweigh the costs, may mean that there is no one to lobby for changes to the ownership prohibition.

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[9] Of course, this rationale presumes that lawyers are somehow less susceptible than non-lawyers to advancing their own interests at the expense of clients' interests. This is theoretically suspect and an open question empirically. But many have their doubts—the same ABA member continued: "It's a totally romanticized view of what the legal profession is like today. Lawyers themselves are very much concerned with the bottom line" (Garamfalvi, 2006).

The idea of lifting this prohibition has had only very limited discussion in the US legal profession (Garamfalvi, 2006). However, Gilson & Mnookin's "surprises" seem poised to come from overseas, as the prohibition is likely to be removed in the UK fairly soon. A repeal of the prohibition has been introduced to Parliament as part of a bundle of proposed reforms to the UK legal profession (Clementi, 2004; Garamfalvi, 2006), and would indeed allow law firms to have outside owners and hence be publicly traded. Such a development in the UK legal industry, where many of the world's largest law firms are located, will very likely bring much higher visibility to the issue in other countries. For example, the Canadian Bar Association has begun discussion the implications of the UK proposal and the merits of repealing their own ownership restrictions (Emerging Professional Issues Initiative 2005; Makin, 2004).

Since the UK legal industry features some of the world's largest law firms, it might seem consistent that the repeal of the outside ownership prohibition would originate in the UK, as these firms would have the greatest need for capital and perhaps benefit least from the purported benefits of the partnership ownership model. So it is interesting to note that the impetus for the ownership reforms in the UK have not come from law firms clamoring to access outside capital. In addition, there is little indication that the industry has recently experienced substantial increases in the demand for capital. Rather, the government is seeking to increase the availability of legal services to the general public by increasing competition and transparency in the industry (Clementi, 2004). One observer has remarked that the law firms themselves have been strangely passive regarding the reforms, except in opposition to increased government oversight of the profession (Garamfalvi, 2006).

Overall, the legal industry by itself does not provide much variation with which to draw inferences about the economic issues of exclusive insider ownership vs. public ownership.

Public Accounting

As with law firms, US public accounting firms face prohibitions on outside ownership, as a precaution against conflicts of interest. Certified public accountants (CPAs) practice under regulations maintained by the profession's central association (the AICPA in the US) and reinforced by state-level government licensing boards. These regulations traditionally included a prohibition on non-CPA ownership of CPA firms, which effectively precluded public ownership. This regulation is intended to help preserve CPA's "independence", meaning that the CPA makes judgments and offers advice based solely on professional expertise rather than other biases, particularly financial biases (AICPA, 2004).

The ownership prohibitions in accounting, however, do not cover all firms that provide accounting services because the accounting profession's jurisdictional monopoly only applies to audits. Audits of publicly-traded firms must be done by CPAs, but providing non-audit accounting services does not require a CPA. Thus, there are firms that provide non-audit accounting services which are not subject to the ownership restrictions—and interestingly, a number of such firms are publicly-traded. Most of these public firms focus on tax advice and preparation, such as H&R Block, Jackson Hewitt, Kaye Kotts, and Gilman & Ciocia. But several, including RSM McGladrey and Century Business Services (now CBIZ), provide a broad range of accounting-related services (e.g., financial analysis, forensic audits, tax planning) as well as other management consulting services.

A particularly interesting recent phenomenon has been the emergence of the so-called "accounting consolidators." In the second half of the 1990s, several of these publicly-traded accounting services firms formed subsidiaries to acquire mid-size accounting partnerships (leading consolidators included American Express Tax & Business Services, H&R Block, Century Business Services and Gilman & Ciocia). The consolidators provided capital to the partnerships both to allow the partners to liquidate some of their ownership stake and to fund investments in IT and expanded specialty services (Goldwasser, 1999; Howard, 2002; Krotman & Sinkin, 2000). To work around the ownership prohibitions, the consolidators purchased the partnerships' non-audit practices (the "non-attest assets") and left the existing partnership as an affiliated but independent entity to provide audit services. In other words, this was an attempt to introduce outside ownership into accounting, in order to inject outside capital despite the ownership prohibitions.

However, after the downturn and accounting scandals of 2000-2001, the consolidator movement cooled considerably (Howard, 2002; Krotman & Sinkin, 2000). Two problems arose. First, consolidators' market valuations dropped considerably, which severely impaired the ability to make acquisitions and provide partnership with fresh capital. Second, the profession and the SEC have raised concerns about the extent to which these "alternative practice structures" violate the ownership prohibitions and other auditor independence regulations (Cvitanov, 2000; Goldwasser, 1999). In addition to ceasing acquisition activity, two of the leading consolidators exited, one via merger with another player and one via a refocusing on financial technology services. Similar consolidators emerged and have since cooled in the UK and Australia in the same time period (Howard, 2002; Neveling, 2005).

As of 2006, the long-term success of the consolidator model was uncertain. However, it seems to be playing an important role in recent debates over whether and how to reform the professional regulations, including those on ownership. Citing a need to adjust to current practices and to help CPAs maintain competitiveness vis-à-vis non-CPA financial advisory firms, the AICPA recently encouraged relaxed ownership prohibitions. [10] While the new rules still prohibit public ownership of audit firms, the prohibitions are clearly subject to revision.[11]

Summary

In contrast to law firms, the largest accounting firms are very large organizations with tens of thousands of employees and operations in scores of countries. However, they are still organized as professional partnerships and, as such, often provide the primary illustration of the notion that professional services should be uniquely owned and organized. However, this exception is an artifact of regulatory prohibitions rather than accounting firms' choices of optimal ownership structures. In fact, firms that provide complex non-audit accounting services are publicly-traded and are attempting to create hybrid organizational structures to also provide auditing despite the prohibitions. And as the accounting profession adjusts its rules to confront competition from non-CPA firms, it may be the case that ownership prohibitions will be lifted to the point of allowing outside ownership.

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[10] Specifically, the AICPA recommends (a) allowing non-CPA ownership of CPA firms, as long as (a1) majority control remains with CPAs and (a2) non-CPA owners are still active participants; and (b) removing ownership restrictions on firms of CPAs that do not perform attest services (public audits). Implementation of these revisions is complicated, however, by the fact that regulation of CPAs and public audits in particular also involves state governments and the SEC.

[11] In Australia, for example, the parliamentary committee overseeing accounting has raised the idea of allowing audit firms to go public, as a means to improve the transparency of their practices (Ravlic, 2002)!

Advertising

In 2003 there were 10 public firms among the top 25 largest. However, these ten dominated the industry, with just the top four representing almost 50% of global market share. The largest private firm (even though ranked #11) was dwarfed by the size of the largest public firms. But for the first century of the U.S. advertising industry's history (from the 1860s to 1962), all its firms were privately held.[12]

The advertising industry, too, had self-imposed restrictions on public ownership. The industry trade association—the American Association of Advertising Agencies (4As)—imposed several ownership restrictions on its members, including a prohibition against having owners who were not involved in managing the agency: i.e., no outside investors. As in law and accounting, the stated reason for the restrictions was to prevent conflicts of interest that might compromise an agency's ability to serve clients fairly, as well as to prevent disclosure of confidential client information.

But these ownership restrictions posed a much weaker barrier than those in law and accounting. The 4A's did not regulate entry into the industry via a certification process (like bar exams and CPA exams). Not only was the state not at all involved in regulating the industry, but firms could "practice" advertising without even being members of the industry association.

From 1962 to 1973, a wave of 21 ad agencies went public, eight of whom were among the industry's top 25 firms.[13] The first firm to go public was a two-year-old agency that had not joined the industry association and was thereby unaffected by the ownership

[12] One agency actually went public as early as 1929 (Albert Frank–Guenther Law), in order to raise money to pay off the mortgage on its office building, but it re-privatized soon thereafter.
[13] U.K. agencies also began going public in the early 1960s. In fact, a U.K. agency was the first to IPO in 1961

restrictions. A year later, the 4A's member firms voted to repeal the ownership restrictions (Advertising Age 1963; Business Week 1964), paving the way for the other IPOs.

Why 1962? The evidence suggests that the impetus came primarily from the booming stock market and the possibility it offered owners to cash out, rather than from changes to the industry itself, such as an increased demand for investment capital. In terms of investment needs, the advertising industry's growth rate and average profitability was not particularly high in the early 1960s (see Figure 1). And there is no mention in the trade press of some increase in the capital intensity of the business. There was a relatively new advertising medium in the form of television, but as with other media, ad agencies did not own expensive production equipment, outsourcing such production to specialists (Cook & Nohria, 1991).

Instead, the contemporary trade press indicates that a booming stock market lead investment bankers, who were looking for new sources of deals in the relatively untapped service sector, to solicit ad agencies to go public.[14] Consistent with this, Figure 2, which shows the number of advertising IPOs (columns) and total IPOs (line) in the U.S. from 1960 to 2000, indicates that agency IPOs began and peaked during "hot" IPO markets (Ritter, 1998).

Furthermore, most ad agencies floated in order to provide owners with liquidity and diversification—i.e., to cash out—rather than to finance investment. Of the thirteen agencies for which detailed IPO data is available, nine had 100% of the IPO proceeds go to selling stockholders rather than to the firm itself (i.e., they were secondary offerings). Of the remaining four, where just under 50% of the proceeds went to the firm's treasury, two used

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[14] Reports include: "Stock underwriters reportedly have been stepping up their activities in the agency field, trying to sell the agencies on the advantages of public offerings." (Anon, 1963).

those treasury funds to pay off debt that the firm had incurred to buy out retiring owners in previous years.

By the mid-1970s, however, one might have drawn the conclusion that public ownership *was* a mistake for ad agencies. Of the 21 agencies that went public, almost one-third (six) re-privatized by 1978, and two failed. All posted poor financial results and had very depressed stock prices. But that conclusion would fail to consider the overall context of a severe stock market downturn and overall economic downturn in the early 1970s, which hurt the advertising industry particularly hard, as advertising spending is one of the first expenses that gets cut in a downturn. In fact, one empirical study shows that between 1962 and 1980, publicly traded ad agencies performed as well as (if not slightly better than) private ones (von Nordenflycht, 2007). Additionally, they also won creativity awards at the same or higher rate than private firms, indicating that they were not disadvantaged in a particularly human capital-intensive dimension (von Nordenflycht, 2007).

Who went public and who stayed private? Not surprisingly, larger ad agencies were more likely to go public (von Nordenflycht, 2007). Interestingly, though, quite a few smaller agencies went public. But public ownership does seem to have been uncompetitive for these smaller agencies: very few survived as independent public firms (either re-privatizing, failing or being acquired) and the performance of small public agencies *was* lower than that of small private agencies. This then is consistent with the basic theory of the partnership. It is also interesting to note, though, that quite a few large agencies stayed private through the mid-1980s, and there were no performance differences between large public and private agencies: so both public and private ownership were equally viable.

Another noteworthy pattern is that many of the early adopters of public ownership were "deviants" or "outsiders" to the industry on some economic or social dimension. As noted, the first agency to go public was a start-up that opted not to join the industry association and was described at the time as a "creative maverick" (Printer's Ink 1962). Those that followed were also different in some way, either start-ups, heavily Jewish, headed by women, or based outside of New York. The mainstream agencies—larger, old, New York-based, WASP-dominated—were slower to go public, even though they may have been better suited to it, both in the need for liquidity (given their size and age) and in connections to investment banks. This suggests that norms about "appropriate" forms of organization may have played an important role in the choice of ownership type, independently of considerations of financial payoffs or competitive advantages.

In the mid-1980s, the advertising industry began a major consolidation. This consolidation was driven by a few large publicly-traded ad agencies that formed holding companies to acquire other large ad agencies. One result of this consolidation was the disappearance of large private ad agencies. Since the mid-1980s, private (and public) ad agencies of any size have been acquired by one of the few holding companies. As previously noted, by 2003 the industry was dominated by a small number of publicly traded holding companies.

But as with the initial emergence of public ownership in the mid-1960s, the dominance of public ownership after the mid-1980s seems unrelated to changes in the economics of ad agency production. One analysis argues that the consolidation into holding companies was driven not by increases in scale or scope economies or by geographic and functional diversification of client advertising, but by increased access to capital markets (von Nordenflycht, 2005). In this argument, the publicly-traded holding companies played an intermediary role, connecting outside investors with ad agency owners who wanted to cash out.

Summary

While the advertising industry has gone from having no public firms to being dominated by a handful of public firms, there is little in the industry's history to suggest a change in the underlying economics that increased capital intensity or increased standardization. Even without an obvious change in conditions, public ownership has turned out to be a competitive form for large agencies—to some degree this would seem to challenge the partnership theories. In this industry, the attraction of public ownership is not as a vehicle for raising investment capital but as a way to provide owners with liquidity.

On the other hand, the pattern for small agencies is consistent with the partnership theories. Small public agencies have not survived long and underperformed their private rivals while they did. Public ownership seems sub-optimal for smaller firms. Still, this is hardly unique to professional services. Studies of IPOs in general have shown that smaller firms that go public tend to underperform comparable private firms. And this could simply be because of the substantial fixed costs of public ownership, rather than a decreased ability to attract, develop and motivate human capitalists.

Investment Banking

In 2003, all of the top 25 investment banks were publicly traded. As Table 1 shows, though, this was not at all true in 1960. All but one of the major investment banking firms were partnerships (or private corporations with no outside owners).

Here too, the proximate reason for the absence of public corporations was regulatory. In this case, the New York Stock Exchange (NYSE) prohibited its members (i.e., the brokerage firms that traded stocks on the exchange—not the corporations listed on the exchange) from being publicly traded. Specifically, prior to 1970, the NYSE reserved the right to approve all owners of member firms. This effectively prohibited public corporations, whose ownership was widely diffused and changed hands frequently (Jenrette, 2002; Lufkin, 2002). In the 1960s, publicly stated reasons for the preservation of this prohibition included preventing organized crime from infiltrating the NYSE (Jenrette, 2002) and the encouraging less risky behavior because of the unlimited liability of partnerships (Donaldson, 2002).[15] However, insiders and observers generally agreed that the rule was preserved primarily for anti-competitive reasons: it prevented large, publicly-traded banks from joining the NYSE, forcing them instead to pay the smaller NYSE firms for securities trading services (Jenrette, 2002; Wells, 2000).[16]

But NYSE membership is not a requirement for the practice of investment banking, so this prohibition did not preclude publicly-traded investment banks *per se*. Firms could underwrite security issues, sell stocks to the public, even trade stocks on other exchanges without being a NYSE member. First Boston, for example, was publicly traded from its founding in 1933. As such it was denied NYSE membership, but was still a leading player in the industry. So again, the absence of public corporations was not evidence that public ownership was economically infeasible for investment banks, as the exception of First Boston also illustrated.

In the late 1960s, Wall Street experienced what has been termed the "paperwork crisis" (Wells, 2000). A long bull market, broadening public participation in the stock market, and the rise of institutional investors who traded in large volumes (Donaldson, 2002;

[15] This latter argument was hardly credible given that members could be and often were organized as private corporations with limited liability.
[16] Another anti-competitive reason to preserve the prohibition was that the NYSE members feared that disclosure of the industry's profitability would create pressure from institutional clients for the removal of rules establishing fixed commission rates—i.e., an end to restrictions on price competition (Hayes, 2000).

Jenrette, 2002) led to surging trading volumes. This volume overwhelmed the transaction processing capabilities of many brokerages, which were largely manual and involved the physical delivery of stock certificates (Wells, 2000). As trades failed to get documented or executed, many brokerages lost track of their liabilities. When the bull market ended in 1969 and trading revenue declined substantially, many Wall Street firms found themselves in financial crises. By the mid-1970 ten firms had been liquidated and the SEC and NYSE had to engineer bailouts of three of the largest brokerages (Wells, 2000).

Participants and historians agree that the developments of the late 1960s demanded increased access to capital for Wall Street firms, for investments in both working capital and fixed capital. The higher trading volumes and especially an emergent demand from institutional investors for large block trades which were facilitated by short-term funding from the brokerages (Donaldson, 2002; Jenrette, 2002; Lufkin, 2002) increased the industry's working capital requirements. And the transaction processing crisis led to large investments in computing systems (Morrison & Wilhelm, 2004; Wells, 2000). Ironically enough, the partnerships of Wall Street were not well-positioned to make these investments. Not only did their ownership structures hinder access to outside equity, but the internally-sourced capital was highly vulnerable: individual partners could leave their firms and withdraw their capital usually on 90 days notice (Wells, 2000)—which they typically did in droves when firms ran into financial difficulties, which was precisely when firms needed a capital cushion (Groysberg et al., 1999; Jenrette, 2002; Lufkin, 2002).[17]

It was in this context of crisis and an increased demand for capital that the NYSE removed its prohibition on members being publicly traded. Still, the NYSE needed goading

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[17] It is also commonly asserted that partnerships were risk-averse, with senior partners avoiding long-term investments in things like computer systems (Donaldson, 2002; Jenrette, 2002; Lufkin, 2002; Wells, 2000).

by a young, upstart member. Donaldson Lufkin Jenrette (DLJ) was founded in 1959 with the idea of targeting the emerging institutional investor segment with high-quality research. The founders claim to have had it in mind to go public from the time they were founded (Donaldson, 2002; Jenrette, 2002). By focusing on institutional clients, DLJ was an early pioneer in large-block trading and thus experienced early the increasing demand for working capital to facilitate such trading. In 1969, the firm announced to the NYSE that it was filing a registration with the SEC to go public[18] and threatened to take its large block trading to competing stock exchanges if it was not allowed to go public. Given the financial crisis, the NYSE didn't want to lose business to other exchanges. And other powerful NYSE members, such as the industry's largest player, Merrill Lynch, quickly supported DLJ's move to reform the ownership requirements. Thus, in 1970, the NYSE voted to allow members to be publicly traded (NYSE, 2006).

After the repeal of the NYSE prohibition, the diffusion of public ownership in investment banking occurred roughly in three stages, each associated with different segments of the industry (see Table 3 for a chronological list of transitions to public ownership in the US investment banking industry). The early adopters in the early 1970s were almost all "retail" brokerage houses: firms that sold stocks to the public via extensive branch office networks. A second wave of transitions to public ownership (either via IPO or via acquisition by a public firm) occurred in the mid-1980s, this time involving "wholesale" investment banks: firms that did not do retail distribution but instead focused on underwriting, trading and advisory services (such as M&A advising) (Morrison & Wilhelm,

[18] For which it had prepared for a year in secret with help from First Boston, which was eager to see the NYSE ownership restrictions lifted

2004). The third wave, from the mid-1990s to mid-2000s, featured firms with strengths in equity underwriting and advisory services, especially smaller "boutique" investment banks.

Morrison and Wilhelm (2004) argue persuasively that the sequence of ownership transitions was driven by differences in the value of capital investments across the industry's segments. The retail segment was more capital intensive than the wholesale segment because of the branch networks. In addition, it also faced the greater need for IT investments in the 1960s to deal with high transaction volumes. IT investments were not as valuable to the functions of the wholesale banks until the rise of the minicomputer and microcomputer in the late 1970s and through the 1980s. The capacity for powerful computation at the desktop facilitated the creation of new, more sophisticated financial products and trading markets (e.g., derivatives), which contributed to the wholesale banks' transitions to public ownership. Finally, the "holdouts", which did not go public until the mid-1990s or later, were firms whose primary functions (equity underwriting, advising, research) were the industry's least capital intensive and most dependent on human capital.

This explanation, then, seems consistent with the standard theories of the professional partnership: (1) increases in the demand for capital led to pressure to remove the ownership prohibitions and to the IPOs of firms with the greatest needs for capital; yet (2) not all the firms went public as soon as they were allowed to, and one inference from that is that the professional partnership model was still the superior choice for those firms. The third wave, however, seems a bit puzzling as the notion that these firms experienced an increased demand for capital seems much less compelling. In this wave, a number of smaller, specialized boutique firms transitioned to public ownership, which seems to challenge the notion that the partnership structure has advantages for small, human-capital intensive firms.

A closer look at this wave seems warranted, particularly at the high-profile IPO of Goldman Sachs.

Goldman Sachs

The IPO of Goldman Sachs in 1999 was a very high-profile event and an interesting case for several reasons. Its high profile stemmed from the twin facts that Goldman Sachs (hereafter, Goldman) was distinct in the industry for being perhaps the most respected firm—known for its top performance, its high-quality talent, and its distinctive culture (Caplen, 1995; Economist, 2006; Groysberg et al., 1999; Lorsch & Tierney, 2002; Serwer, 1998; Wayne, 1984)—as well as for being one of the last large partnerships. In fact, many industry participants and observers assumed that the two were related: namely, that the partnership structure was a key source of Goldman's superior performance by fostering its unique "team" culture and its ability to attract top talent. In other words, Goldman seemed to be the quintessential illustration of the theory that partnerships were associated with superior incentives for human capital. So why did Goldman hold out so long, why did it finally decide to go public, and what has happened since?

Groysberg, Matthews, Nanda & Salter (1999) provide useful details regarding the first two questions and are the principle source for this and the next several paragraphs. Goldman was founded as a partnership in 1882 and was still a general partnership (with unlimited partner liability) by 1986. It first considered the question of whether to go public in 1986, during the "second wave" of IPOs which included Morgan Stanley and Bear Stearns. The proposal was discussed and turned down by the partners. At the time, Goldman was much more highly capitalized than its rivals (Morrison & Wilhelm, 2004), so its demand for outside capital was lower. In addition, Goldman acquired additional capital by selling non-voting ownership stakes to some outside investors, reducing the need for an IPO.

Goldman partners then considered and rejected the idea of going public four more times before finally voting yes in 1998. The nature of the pros and cons were essentially the same in each debate. The rationale for going public was to provide "permanent capital." As other partnerships experienced in the late 1960s, Goldman saw substantial numbers of its partners retire and take their capital out of the firm precisely in the down years when the capital was sorely needed. Interestingly, an IPO was not viewed as necessary to finance the firm's *investments*, either in IT, diversification or globalization. Growth could be financed with partner capital and debt. The issue was protecting the firm from capital withdrawals during downturns.

The principle argument against going public was the possibly detrimental effect on the firm's culture and its ability to attract and retain talent. It was not only outsiders that linked Goldman's culture to its competitive success—insiders, too, saw the culture as a chief competitive advantage. The Goldman culture was distinguished primarily by a greater spirit of teamwork than existed at rival banks. The partnership structure was seen as a key mechanism (although there were others as well) for preserving this culture, as it created a greater sense of identity with the firm and with one's colleagues. Additionally, the ability to offer a Goldman partnership was seen as important to *attracting* top talent, as it was one of the most prestigious positions on Wall Street, and *retaining* top talent, since it took years to achieve and led to staying more years once achieved.

Five times between 1986 and 1996, the culture argument won out. So what changed for the 1998 vote? One of the largest changes was the growth in the firm's proprietary trading business. By the early 1990s, trading was a rapidly growing part of Goldman's business but also put large amounts of the firm's capital at risk and exposed the firm to much greater volatility. This led to a crisis in 1994 when trading contributed to significant overall losses and 30% of the partners decided to leave the firm and take their capital. Again Goldman raised new capital by selling non-voting stakes to outside investors but the issue of permanent capital became of increased importance.

Trading also created problems with the firm's compensation policies. Trading is a highly independent business and rival firms and hedge funds offered much more individually-based compensation to traders. To build and grow its trading business, Goldman in the early 1990s introduced more individually-based compensation for partners and non-partners. This may have had substantial effects on the firm's culture, as it reduced the "peer-status" among partners and also led to instances of non-partner traders receiving higher compensation than some partners. Goldman also violated its long-standing practice of no-lateral-hires, which was seen as another culture-building mechanism, in order to build its trading practice. Thus the internal features of Goldman were increasingly departing from the archetypal professional partnership. A further departure occurred in the mid-1990s as the firm added more hierarchical levels to govern its larger, globalizing business more efficiently.

Finally, in 1998, the potential market valuation of Goldman was extremely high, because of the overall buoyancy of the stock market—much higher than when the firm previously considered an IPO in 1996. So by 1998 Goldman had a much more volatile business because of trading, had already eroded key internal features of its partnership model, and could expect to receive a huge valuation, all of which apparently made the benefit of an IPO seem greater and the cultural cost of an IPO seem less.

Despite the IPO, Goldman tried to retain key aspects of the partnership ownership structure. For one, the firm remains controlled by the partners. Only 12.6% of the firm was floated, with 48% remaining in the hands of the partners and 18% in the hands of the existing outside investors and the retired partners, who contracted to vote their shares in accordance with those of the partners (Spiro, 1999). In addition, the position of partner has been retained, with elections of new partners continuing. Partners continue to draw earnings from an annual partnership pool (Smith, 2000). Furthermore, ownership of the firm has actually been more broadly distributed than under the partnership, with 20% of the shares allocated to non-partner bonus and benefit plans. So while some aspects of the archetypal professional partnership were violated while Goldman was a private partnership, other aspects have been retained while a public corporation.

Seven years after its IPO, Goldman has shown few signs of any ill effects. According to a recent *Economist* survey, the firm continues to outperform its rivals in terms of financial performance (Economist, 2006). More specifically, there are very few signs of cultural erosions that have led to incentive problems. While there was increased turnover around the IPO, it was still quite mild relative to industry standards (Smith, 2000), those that have left have mostly gone to alternative institutions (hedge funds, startups) rather than rival investment banks, and Goldman is still known for attracting and retaining top talent (Economist, 2006). Recently, Goldman's performance in asset management and research has been rated as "mediocre"—perhaps suggesting lower levels of human capital—but more systematic evidence would be needed to draw any conclusions.

Again, though, it may be that Goldman has a different business, as trading represented 57% of its 2005 revenue, compared to 15% for investment banking. As noted earlier, trading might be a more individually-based (as well as capital-intensive) business which is less dependent on the firm's "team" culture, such that Goldman could still perform very well even if public ownership necessarily hindered the maintenance of said culture. But overall, the basic concern that a public corporation could not match the incentive capabilities and human capital levels of a professional partnership has not been borne out as yet.

Summary

Overall, the emergence and diffusion of public ownership in investment banking seems closely tied to increases in the value of capital, whether for IT investments or working capital to provide more risk finance to clients and to fund proprietary trading. This is consistent with one side of the standard theory of the professional partnership. In other words, here we see what the professional partnership *cannot* do: it is disadvantaged in accessing and deploying non-human capital. However, there is still not much direct evidence to show what the professional partnership *can* do—to show that the partnership model is advantaged, under certain conditions, in attracting and motivating human capital.

The strongest evidence is the fact that many banks did not go public immediately after the repeal of ownership restrictions in 1970 and a few were still private in 2004. Morrison & Wilhelm (2004) provide such an interpretation:

> "The primary holdouts [as partnerships] among investment banking functions include corporate advisory services and to a lesser extent equity underwriting and complex financial engineering and trading functions (including hedge funds). Over the same period, the markets have witnessed the rise of prominent boutique firms focused typically in one of these areas. *Our theory suggests that such functions, assuming they remain heavily dependent on tacit knowledge, are not optimally managed within large publicly-traded corporations*. [my italics]"

It would be nice, however, to have some indication that in certain segments, professional partnerships outperformed public corporations or that partnerships that went public became less competitive. It may be instead that public ownership is equally viable among small, non capital-intensive firms.

The investment banking industry offers support for the idea that the professional partnership model is hard to sustain as organizations get large and/or need significant risk capital. But the evidence that the model has countervailing advantages under conditions of less capital intensity is less compelling. The absence of public corporations before 1970 was due to anti-competitive regulations. And there have been no studies of the relative competitiveness of partnerships vs. public corporations. The strongest evidence is the fact that quite a few banks remained partnerships for quite some time after 1970, with some evidence that this was linked to lower needs for capital. However, the IPOs of small boutiques over the last decade challenge the notion that even these less capital-intensive functions are better operated via partnerships.

Management Consulting

Analyzing ownership history in the management consulting industry is more problematic than in the other industries because the boundaries of the industry are harder to define: it is not so straightforward to decide which firms are properly considered "management consultants." Partly because the field does not have an official jurisdiction, a wide variety of advisory services can be included, from corporate strategy to marketing to logistics to IT systems, etc. The boundaries are particularly hard to judge in the realm of IT consulting, where leading firms may offer pure software development services and even computer facilities outsourcing, which seem like different fields: e.g.., should EDS count as one of the world's largest consulting firms? Broadly speaking, one might posit three distinct segments: IT consulting, HR consulting, and management consulting. This analysis takes a relatively broad approach, as greater variation in types of service may shed more light on the choice between private and public ownership.

In 2003, 17 of the top 25 US consulting firms were publicly traded. To a significant degree, the current distribution of public vs. private ownership is consistent with the factors identified in theories of the partnership. In a study of 100 large consulting firms, Richter and Schmidt (2006) show that firm size, capital intensity, and degree of service standardization (vs. customization) are all significant predictors of public vs. private ownership. But here, too, the story was quite different in the recent past. Understanding the emergence of public ownership in this industry is facilitated by looking at each segment separately.

IT Consulting

IT consulting firms began going public in the 1960s, which was only the second decade of the industry's existence (McKenna, 2006). The founders of many firms in this space came from technology backgrounds, hence the firms did not inherit a "bureaucratic professional" (McKenna, 2006) heritage (e.g., accounting and law), with its prohibitions on outside ownership. As in advertising and investment banking, these IPOs occurred during the broader IPO boom of the late 1960s (shown in Figure 2).

However, several of the largest IT consulting firms remained private partnerships until 2001. These were the consulting practices of the large accounting partnerships. As such, they inherited not only the ownership model of their accounting parents, but also faced the aforementioned ownership restrictions. So once again, the large partnerships were not *allowed* to be publicly traded. In 2001, after corporate accounting scandals led to internal and external pressure on the accounting firms to divest their consulting practices, four of the Big Five consultancies quickly became publicly-traded, either via IPO (Andersen, KPMG) or acquisition by a publicly-traded parent (PricewaterhouseCoopers/IBM, Ernst & Young/Cap Gemini). These sales to outside owners, however, were not intended to fund investment, but rather to pay off the accounting partners in the original firms. So, as in advertising, the value of outside investment was in cashing out owners' intangible value rather than funding capital investments.

<HR Consulting – tbd>

Management Consulting

The field of management consulting grew out of industrial engineering and especially cost accounting in the 1920s (McKenna, 2006). As the field developed its own identity, it also adopted, consciously and unconsciously, attitudes and practices from the bureaucratic professions it grew out of. For example, an industry association—the Association of Consulting Management Engineers (ACME)—was formed in 1929 and began to promote a professional code of ethics (McKenna, 2006). Not surprisingly, this code included a prohibition on public ownership (either as in independent firm or a subsidiary of a public parent) for much the same reason: to prevent consultants from compromising the quality and impartiality of their work under pressure to deliver shareholder returns (Klein, 1969; McLean, 1970).

Like advertising, however, membership in the industry association was not required to practice consulting.[19] In fact, ACME's membership did not encompass much of the industry: in 1969, for example, it only had 45 member firms (Klein, 1969). So this prohibition was a relatively weak barrier to outside ownership in the industry.

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[19] In fact, the ACME members actively resisted the establishment of any certification procedures, voluntary or mandatory <McKenna>.

The first management consultancies to go public did so in the same IPO wave of the late 1960s that swept up advertising agencies and investment banks as well. At least three consultancies went public: Science Management Corporation in 1968, Arthur D. Little (ADL) in 1969, and Booz Allen & Hamilton (Booz), the industry's largest firm, in 1970. Another of the industry's leading players, Cresap McCormick & Paget (CMP), was acquired by Citibank in 1970. (As for the ACME ownership prohibitions, they were lifted when Booz decided to pursue its IPO).

Why did consultancies go public then? The explanation seems more akin to the advertising industry than to investment banking, as it appears to have been about cashing out during buoyant markets rather than any increased need for investment capital. The consulting industry experienced strong growth in the 1960s (Klein, 1969). Thus, firms' values had appreciated substantially, making it more difficult for retiring owners to sell their shares to junior partners. The hot IPO market offered an attractive alternative succession mechanism.

But unlike in advertising and investment banking, public ownership didn't persist and diffuse in management consulting. Two of the industry's most prominent firms, McKinsey and A.T. Kearney, remained partnerships during the 1969-70 wave; Booz re-privatized in 1975, only five years after its IPO; CMP's partners repurchased the firm from Citibank in 1977; and ADL ultimately re-privatized as well by 1988. Even in the hot IPO market of the late 1990s, when many Internet-related consultancies (perhaps better viewed as IT consultancies), and even some "boutique" management consultancies (e.g., LECG, Diamond Technology Partners) went public, the leading players (McKinsey, Booz, BCG, Bain) stayed private.

Given this pattern, it seems reasonable to claim, as a director of one leading consultancy has, that: *"by and large in the consulting industry you'd have to say that public ownership is a failure."* (personal interview, 2003). That the leading consultancies remain private partnerships despite the absence of any ownership prohibitions provides perhaps the greatest challenge to the conclusion that the partnership model has only existed because of such prohibitions. A closer look the cases of McKinsey and Booz Allen provides a more subtle interpretation.

McKinsey & Company

McKinsey was founded in 1926 by James McKinsey, an accounting professor at the University of Chicago. By the 1940s, the original firm had split into two firms—McKinsey & Co. (in New York) and A.T. Kearney (in Chicago)—and the managing partner of the former, Marvin Bower, adopted "professionalism" as the firm's key source of differentiation. In particular, Bower hoped to imitate corporate law firms and thus establish an image as trusted boardroom advisors (McKenna, 2006). The push for professionalism involved adopting not only the language and behavior of professionals (such as insisting that the firm be labeled a "practice" rather than a "business") but also the Cravath employment model of the leading law firms (Galanter & Palay, 1990), which entailed recruiting new consultants directly from top graduate programs and establishing a strict up-or-out promotion-to-partner policy (McKenna, 2006). In other words, one of the main aspects of McKinsey's strategy was the adoption of organizational characteristics commonly associated with professional service firms (and law firms in particular). In making this argument, McKenna (2006) points out that some of McKinsey's key rivals (such as Booz Allen and CMP) did *not* adopt such processes and structures as they pursued alternative dimensions of differentiation. For McKinsey, then, the firm's choice of ownership model is not just a function of what might provide optimal incentives—it also must be consistent with a professional image. Thus, the choice not to go public may well have been driven by the fact that the "Ur" professional services firms—law firms and accounting firms—are still partnerships, even though those models may be largely a function of regulatory prohibitions.

Booz Allen & Hamilton

Booz Allen Hamilton was founded as a partnership in 1914 and was converted to a private corporation in 1962. By 1969, while the firm was the industry's largest, ownership was concentrated in the hands of six senior officers.[20] The primary rationale for pursuing an IPO was to cash out those six senior officers. The company's shares had appreciated significantly during the rapid growth in the 1960s and the junior officers simply could not afford to buy back the seniors' shares. The booming stock market made an IPO attractive not only to the senior owners but also to the rest of the officers with small stakes who looked forward to significant share price appreciation as a public corporation. A third rationale—not a driving factor inside the firm, but the publicly-stated rationale—was the facilitation of stock-based acquisitions to further diversify the company's practice (a widely diversified practice was one of Booz Allen's main points of differentiation (McKenna, 2006)). Further evidence that the IPO was about cashing out, rather than a need for investment capital, is the fact that 100% of the IPO shares were secondary sales, with the proceeds going to selling stockholders rather than to the firm.

Going public by itself did not result in any dramatic changes inside the firm. Very few officers left, none of those that left stayed in the industry, and the six "cashed-out" senior officers all stayed. Unfortunately for Booz Allen—as with DLJ and the ad agencies

[20] Unless specifically noted, the information on Booz Allen comes from an interview with a former officer who worked at the firm from the mid-1960s until the late 1990s.

that went public at the same time—the stock market declined precipitously soon after the company's IPO and the consulting industry was particularly hard hit during the recessionary period in the early 1970s as clients severely curtailed their purchases of consulting services as a highly discretionary luxury (similar to advertising). Booz Allen's stock price fell from the IPO price of $24 to $2 by 1972.

This downturn caused several internal problems. One was the visibility of the company's troubles. In addition to the low price of the stock (which also effectively stopped trading for lack of investor interest), the company's layoffs and salary reductions were also more public. Booz Allen's competitors faced the same troubles and had to take similarly unpleasant actions, but they were not so visible. The officers felt personally embarrassed about the situation, particularly as their core product was management expertise. Furthermore, the officers began to question whether they were taking actions that were in the firm's best long-term interests or that were intended to assuage investor perceptions. For example, they felt that they had to forego what they considered "investments" but which might look to outside shareholders like unwarranted perqs or luxuries, such as off-site management committee meetings, increased bonuses, or stock option distributions. Third, because the stock price fell so low, the stock options that had been widely distributed to officers were all under water. No one exercised their options and thus very few insiders actually owned shares. All together, as one insider described it, these problems "hurt the emotional state of the partnership." This insider summed up the officers' displeasure as a public company saying: "We didn't control the firm. The officers did not control the firm's destiny."

The firm bought back its shares in 1975. And this brief experience with public ownership seems to have contributed to a conviction among the firm's senior officers that they will not try it again. As the retired officer said: "especially in … the dot com boom, where …there was a lot of pressure to issue equity in order to get folks to come to work for you… there was just absolutely not the slightest feeling at all among the officers that we should consider going public again…. The 'been there, done that, not going back' mentality was really strong."

It is also notable that shortly after the firm re-privatized, it also restructured its internal governance structures in ways that brought it much closer to the *internal* archetype of the professional partnership. Authority was devolved from a few senior executives to several operating committees, processes were set up to increase the participation of all officers in policy-making, compensation was tied to rank and seniority rather than individual performance, and ownership stakes were spread more broadly. In conjunction with these structural changes, there was a cultural shift toward "a true partnership spirit" which was marked primarily by a reduction in status distinctions among the officers. The term "officer" was replaced with "partner" – and the term "senior partner" was eschewed. In this way, Booz Allen adopted aspects of the "professionalism" that characterized McKinsey.

Summary

At a broad level, the current distribution of public ownership across management consulting firms appears to be generally consistent with the patterns one might expect: firms that are larger, more capital-intensive and that perform more standardized work are more likely to be publicly traded. The dearth of public consultancies in earlier decades in the IT consulting segment can be explained to a large degree by the origin of the leading firms as subsidiaries of public accounting firms and by the fact that the field was still quite young by 1960.

The most intriguing aspect of the industry is the seeming "failure" of public ownership among non-IT management consultancies, especially the largest ones. Despite the absence of prohibitions on outside ownership after 1969 (and only weak ones prior to that), not only have most of the leading firms never opted for public ownership but some that did abandoned it eventually. This seems to be the best case for the argument that the ownership model of the professional partnership is advantaged where capital is unimportant and human capital is very important. However, there are several caveats to such an inference.

First, firms in the management consulting industry adopted various characteristics of professionalism, including organizational structures and ownership prohibitions, in order to build legitimacy as a profession (McKenna, 2006), particularly given the absence of a state-sanctioned monopoly jurisdiction. Thus, consultancies might be even more attuned to the norms of what is "appropriate" (as opposed to what might be feasible or efficient) than the better established professions. Second, the industry's highest profile firm has adopted professionalism as its chief source of distinction, so the choice of ownership structure is conditioned by the need to reinforce signals of such professionalism. Third, Booz Allen's negative experience with public ownership was confounded by a dramatic industry and stock market collapse shortly after their IPO. Fourth, there is not yet any systematic evidence that private consultancies outperform public consultancies.

Here again, then, we can see that the partnership model may be viable and competitive where the demands for capital are not too substantial. But it is harder to conclude that the partnership is *superior* to the public corporation in such an environment. The choice to remain (or re-form) with exclusively inside ownership may be driven by variation in the strength of professional norms—across segments as well as across firms.

DISCUSSION

In drawing inferences from the historical pattern of public ownership across professional services, it is important to reiterate the fact that public ownership violates *one* key dimension of the archetypal professional partnership: the absence of outside owners. Thus, this analysis asks what we can infer about the partnership model's exclusion of outside owners. We cannot infer much about the role of the internal features of the partnership model, as will be discussed later on.

Certainly one of the most important facts that emerges from this historical analysis is the presence (until at least 1963) of non-economic prohibitions on outside ownership in each of the five industries. In most instances, the absence of public corporations (at least among an industry's largest firms) can be attributed to these prohibitions, rather than to choices by firms themselves to eschew outside ownership. This then undermines the common inference that the dominance of the partnership model indicates its economic superiority in the human capital-intensive environment of PSFs. In most cases, the publicly stated reason for these prohibitions was to prevent conflicts of interest—namely, pressure by outside shareholders for short-term profit maximization—that might harm clients (or the public, in the case of auditing). As such, these prohibitions are specific manifestations of a larger professional code of ethics, which is one of the defining characteristics of a profession (Nanda, 2002, 2003).

A second key pattern is that where there is variance in the incidence of public ownership, it broadly correlates with firm size and capital intensity, as would be predicted by most theories of the professional partnership. For example, Figure 3 plots the number of publicly-traded top 25 firms against the average size of the four largest firms in each industry in 2003. With the exception of the public accounting industry, which is attributable to the ownership prohibitions, there is a strong trend to more public firms where there are larger firms. The investment banking industry's particularly high number of public firms is likely a result of its greater demand for risk capital (as previously discussed). Furthermore, at the firm level, in advertising, investment banking and consulting, larger firms were more likely to go public, and in the latter two, so were firms whose operations were more capital intensive. But finding that firm size and capital intensity predict public ownership is hardly surprising. In fact, we don't need any special theory of the professional partnership to make that prediction: both factors are predictors of public (vs. private) ownership in any context, as reflected in the corporate finance literature on that topic (Pagano et al., 1998; Ritter & Welch, 2002).

The historical evidence, then, supports the idea that the partnership model's exclusion of outside owners is *sub-optimal* under certain conditions. When access to capital is or becomes valuable, and ownership restrictions are not in place, it appears that public ownership ultimately becomes a necessity for an industry's largest firms, as in investment banking and advertising.

However, there is much less evidence that the absence of outside owners is *optimal* in other conditions, except for small firm size. Even in the small firm context, while there is some evidence from the advertising industry that public ownership was associated with sub-par performance for smaller firms, similar evidence has not yet been demonstrated for investment banking and consulting. And this may simply reflect the higher fixed costs of public ownership rather than any incentive provision problems.

For larger human capital intensive firms, however, an absence of investment needs (i.e., low capital intensity) has not precluded public ownership. Public firms have arisen in professional services without any obvious increases in the need for investment, as in advertising and consulting. Instead, booming capital markets, and the late 1960s IPO market in particular, made public ownership an extremely attractive mechanism to provide liquidity to senior partners—attractive enough to compel the repeal of restrictions on public ownership. And evidence from the advertising industry indicates no performance differences between large public and private firms. Finally, some of the anecdotal cases which provide the basis for the belief that public ownership is a "disaster" for PSFs seem less compelling when seen in the context of a downturn in the industry, economy, and stock market shortly after those firms' IPOs. In other words, PSFs do not *need* to be held exclusively by insiders. Under conditions thought to favor the partnership model, perhaps the public corporation is equally viable.

What then of the "holdouts"—large PSFs that remained private despite being allowed to go public? In this vein, a fourth pattern is the important role of professional norms. In particular, industry-level resistance to and firm-level opting out of public ownership seems explained to some degree by norms about the "appropriate" forms of ownership in the context of what it means to be a profession. In terms of "holdout" industries, the two fields that have preserved ownership prohibitions, law and accounting, are arguably more institutionalized as professions than the three that lifted the prohibitions. They have stronger central associations and state-sanctioned entry barriers. Thus, it was easier, cognitively and politically, for the other three fields to lift the ownership restrictions. It would be hard to argue, by contrast, that public accounting firms have experienced lower demands for investment (or had small average firm size) than advertising and consulting.

In terms of "holdout" firms, several patterns point to the importance of norms in the decision not to go public. In advertising and investment banking, the pioneering adopter of public ownership was a start-up—a more peripheral "outsider"—rather than the large, central firms. And many of the early adopters in advertising were also outsiders on one dimension or another, which suggests that the central, established firms were more infused with the norms regarding appropriate ownership structures. In addition, senior managers in several of the large advertising firms that stayed private long after most of their rivals had gone public attributed that decision to the feeling that it was the "appropriate" form of ownership for their firms (rather than yielding specific advantages, such as incentives for better human capital) (Moskowitz, 1989). And in consulting, private ownership has been retained as one among many signals of professionalism, as part of a conscious effort by the field in general and leading firms in particular to adopt imitation of established professions as a competitive strategy.

Implications

This historical look at the long absence and recent emergence of the public corporation in professional service fields challenges the growing literature on the professional partnership. In particular, it challenges the common assumption that the large professional partnership has thrived because it suits the economic environment of the professional services, specifically by providing advantages in the attraction, motivation and development of human capitalists. Instead, this analysis suggests that the absence of outside ownership in the professional services stems primarily from two distinctive characteristics: (1) professional norms about appropriate models of ownership and conflicts of interest; and (2) the typically small size of the firms. Not only increases in the capital intensity of production, but even simply buoyant capital markets, can put pressure on the restrictions imposed by professional norms. Once these norms are eroded, larger and more capital intensive PSFs tend to go public, which is what we would expect outside of professional services as well.

This also has implications for the increasing tendency to look to professional service firms for lessons for knowledge intensive firms in general (Alvesson, 1995; Scott, 1998; Teece, 2003). If key aspects of the professional partnership are artifacts of traditional codes of ethics, then scholars should be cautious about holding out PSFs as governance models in an increasingly human capital-intensive economy, particularly when such theorizing is based on "stylized facts" and assumptions that do not hold up to historical analysis. So while some scholars suggest that as the value of human capital increases, corporations will look increasingly like professional service firms (Blair & Kochan, 2000; Lowendahl, 2000; Scott, 1998; Teece, 2003), it may be instead that professional service firms will look increasingly like traditional corporations.

Finally, though, we must again recognize the major caveat that this analysis focuses on the presence or absence of outside owners. We cannot say much about whether the *internal* features of the professional partnership model do or do not yield advantages over the internal characteristics of more standard corporations. There is anecdotal evidence that managers of PSFs that went public believed that the essential benefits of the partnership model came from internal features, and that they could retain or replicate those features as public corporations. One of the founders of DLJ, for instance, noted that "we were a corporation but we acted like a partnership. We had all sorts of incentives to motivate people to be part of a team" (Donaldson, 2002). The chairman of Goldman Sachs argued during the IPO debate that "I don't think our culture has to go away [with an IPO]. … In a public company your choices with regard to governance, how you set strategy and choose leadership, how you reward people and whom you choose to reward will set the cultural reality" (Groysberg et al., 1999). As described earlier, Goldman sought to preserve the notion of a partnership through internal promotion and compensation policies.[21]

This idea is consistent with the argument of Empson & Chapman (2006), who compare two strategically allied consultancies: one a public corporation, the other a private partnership. They find that managers under both ownership models express a similar commitment to the "interpretive scheme" of the professional partnership model—or a "spirit of partnership" (Donaldson, 2002; Lorsch & Tierney, 2002)—which entailed limited managerial authority, high individual autonomy, and long-term over short-term performance. However, the principles are manifested through different organizational mechanisms in each firm. Thus, their study suggests that ownership structure—or more specifically, the exclusion of outside owners—is not determinative of a PSF's internal organization, and therefore a public corporation may be able to replicate the internal characteristics of the partnership model. Two critical questions for future research on this topic then are: (1) do the internal features of the professional partnership yield human capital advantages over more traditional internal models (under specific conditions)? And (2) are the internal features of the partnership model compatible with public ownership?

[21] Accenture, too, tried to preserve some internal partnership features as a public corporation through a structure in which a majority of shares are held by trusts which are required to vote their shares in accordance with the results of votes by the professional partners <Accenture filing – check for accuracy>.

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Table 1: Number of Publicly Traded Firms Among Top 25 U.S. Firms

	1960	2003
Law	0	0
Public Accounting	0	0
Accounting (General)	0	6
Advertising	0	10
Investment Banking	1	25
Consulting	2*	17

Sources: National Law Journal, Accounting Today, Public Accounting Report, Consultants News, Advertising Age, Hoover's Online, Compustat, company websites.

Notes: Top 25 firms identified from industry-specific trade journals. Firms that are subsidiaries are coded according to the ownership status of their ultimate parent.

* Two actuarial consultancies were subsidiaries of publicly-traded insurance companies in 1960. No other large consultancies were publicly traded.

Table 2: Average Size of Largest Four Firms, by Industry, 2002

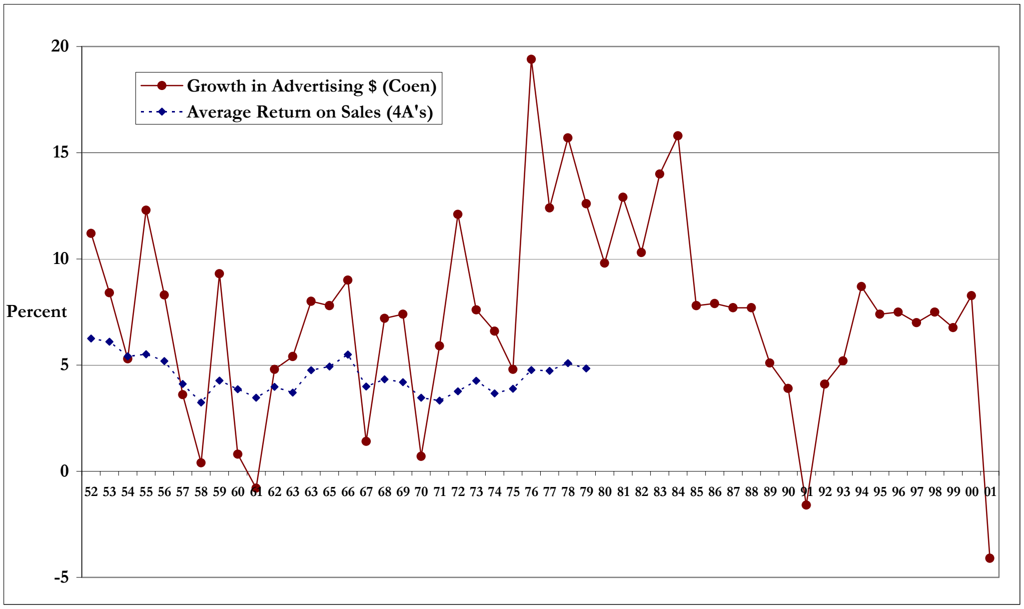
Industry	# Public in Top25	2002 Avg. # Employees, Top4	2002 Avg. Revenue ($m), Top4
Law	0	2,538	840
Public Accounting	0	18,823	4,116
Accounting (general)	6	18,823	4,116
Advertising	10	11,132	1,841
Investment Banks	25	9,541	10,169
Mgmt Consulting	17	13,408	2,732

Sources: 2002 US Economic Census

Table 3: US Investment Banking Transitions to Public Ownership

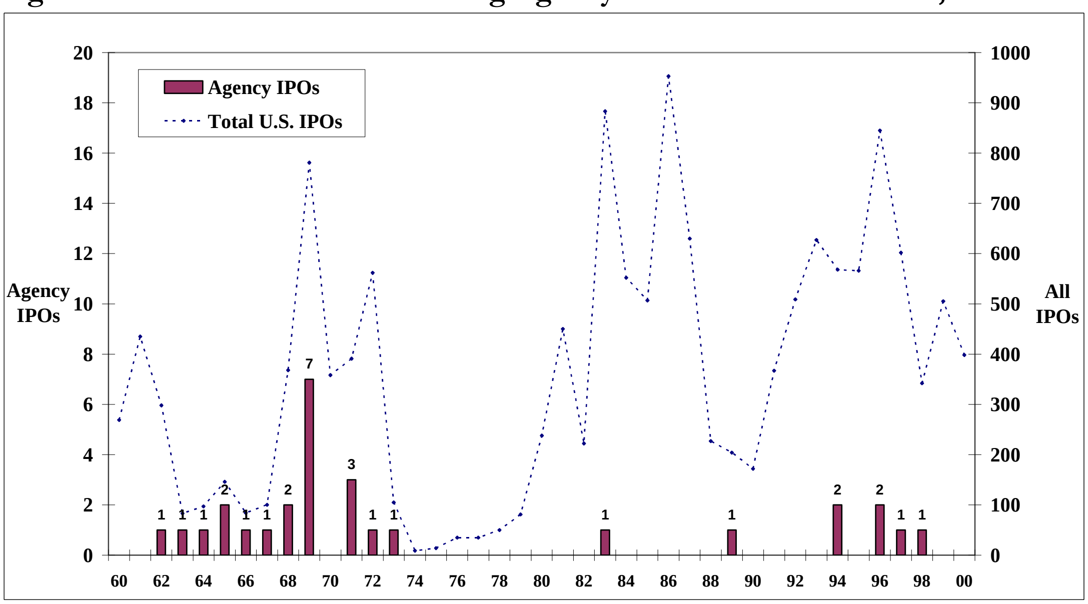
IPO	Acquisition	Year
DLJ		1970
Merrill Lynch		1971
Bache		1971
Reynolds		1971
AG Edwards		1971
Dean Witter		1972
EF Hutton		1972
Paine Webber		1972
	Eastman Dillon	1972
	White Weld	1978
	Shearson Hammill	1979
	Salomon	1981
	Lehmann	1984
Bear Stearns		1985
Morgan Stanley		1986
Alex Brown		1986
	Kidder Peabody	1986
	Smith Barney	1987
Hambrecht Quist		1996
	Dillon Read	1997
	Montgomery	1997
	Robertson Stephens	1997
	Oppenheimer	1997
	Wheat First	1997
	Furman Selz	1997
Goldman Sachs		1999
Greenhill		2004
Lazard Freres		2005
Keefe Bruyette Woods		2006*

Figure 1. U.S. Advertising Industry Growth and Profitability, 1952-2001



Notes: Solid line represents annual growth rate in total U.S. advertising expenditures, from Coen (2002). Dashed line represesnts the average ratio of net income to revenue for approximately 225 agencies, as reported by the Association of American Advertising Agencies (4As) in *Advertising Age* annually.

Figure 2. Number of U.S. Advertising Agency IPOs and all U.S. IPOs, 1960-2000



Notes: Bars (and left y-axis) represent number of IPOs of U.S. firms whose primary business was traditional media advertising (print, radio, television). Foreign firms and firms specializing in non-traditional media (direct mail, outdoor, etc.) are not included. IPOs were identified through a combination of *CRSP*, *Compustat*, *Thomson Research*, *SDC Platinum*, and the *Business Periodicals Index*. Dashed line (and right y-axis) plots the number of total IPOs in the U.S., from Ritter (2004).

Figure 3: Number of Public Top 25 Firms by Size of Top 4 Firms, circa 2003