TRANSITIONAL STRATEGIES FOR INSTITUTIONAL REFORM IN LATIN AMERICA

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ABSTRACT

This dissertation seeks to improve the current understanding of the ways in which institutional reform can promote the development of stock markets in Latin America. Over the past decade, policymakers sought to stimulate the growth of capital markets in the region through the promotion of a standardized set of formal institutions. An example of this approach in the field of company law was the introduction of modern corporate governance practices into nations without a solid enforcement infrastructure. By most accounts, these efforts did not deliver on their promise of stock market development.

This work identifies areas for potential reform. As a means to better understand the operation of Latin American stock markets, this dissertation draws from different sources, including the historical experience of industrialized nations, the available literature on institutional reform, the documented shortcomings of legal reform programmes and hand-collected data from various Latin American countries. The resulting analysis suggests that the promotion of Latin American capital markets may require strategies different to those that were set in motion over the past decade.

The main contribution of this work is twofold. First, this dissertation brings some nuance to the discussions concerning the challenges faced by Latin American capital markets. A proper understanding of these challenges is essential for policymakers in the region, particularly after the onset of the Latin American Integrated Market. Second, this dissertation explores the use of 'transitional strategies' to overcome some of the challenges identified here. The ultimate goal of this project is to inform future reform efforts in Latin America and to offer some insights for policymakers in other emerging countries.

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Introduction

In October 1874, after almost two years of gruelling work, sir Bradford Leslie's famous Floating Bridge opened for traffic. The bridge was the crucial missing link between Calcutta, the capital city of what was then known as the British Raj, and the vast western territories that make up most of modern-day India.[1] At the time, the city of Calcutta was confined to the eastern side of the Hooghly River, a distributary of the Ganges with a foul reputation among sailors.[2] The major local railroad, operated by the East Indian Railway Company, ended on the opposite bank of the river, near the town of Howrah, which left Calcutta virtually unconnected to the region's main system of transportation. Commuters and merchandise going to and from Calcutta had to be ferried across the Hooghly River, 'an arrangement so inconvenient as to be more easily imagined than described'.[3] The need for a bridge connecting Howrah to Calcutta was pressing.

By the early 1870s, bridge-building techniques were sufficiently advanced to allow for the construction of a modern 'fixed railway bridge' that would bring the railroad across the Hooghly River and directly into Calcutta. This, however, did not happen. Charged with the project, sir Bradford Leslie determined that local conditions would make the construction of a 'fixed railway bridge' an excessively costly and drawn

1 'In a general point of view, no member of the community at Calcutta, whether engineer or not, could fail to appreciate highly the work which [Bradford] had carried out. The junction thereby

2 Minutes of the proceedings of the Institution of Civil Engineers (1878) Vol. 53, 3, available at http://www.icevirtuallibrary.com

3 G Huddleston, History of the East Indian Railway (Spink and co. 1906), 196, available at http://www.archive.org

out process.[4] He opted instead to build a less sophisticated 'floating pontoon bridge' by adapting centuries-old technology to the requirements of 19th century India.

Although the 'floating pontoon bridge' was seen as a transitional measure, meant to operate only until local conditions favoured the construction of a railway bridge, it remained in service until 1933, when increasing demand forced the local authorities to replace it with a modern suspension bridge.[5] For close to 60 years, sir Bradford Leslie's transitional Floating Bridge was central to economy and commerce in the region.

There might be a lesson in this story for policymakers currently trying their hand at institutional reform in emerging markets. Latin America, in particular, has long been a testing ground for wide-ranging reform programmes sponsored by supranational organizations. During the second half of the 20th century, ambitious schemes were set in motion across the region to improve social and economic conditions.[6] The main examples include initiatives such as the Alliance for Progress and the Washington Consensus, both sponsored by the United States and implemented under the guidance of supranational organizations.[7] These programmes required Latin American countries to introduce complex reforms meant to correct the imperfections that ostensibly slowed down their growth. Although these initiatives differed in their scope and objectives, they were both

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4 Minutes, Vol. 53 (1878) 3.

5 Floating pontoon to icon of Calcutta, The Calcutta Telegraph (25 June 2005). The Jubilee Bridge was built in 1888 several miles away from Calcutta but did not replace the floating pontoon bridge. Minutes, Vol. 92 (1888) 101.

6 S Edwards, Forty years of Latin American economic development: From the Alliance for Progress to the Washington Consensus, (2009) NBER Working Paper No. 15190.

7 In his inaugural address as President of the United States, John F. Kennedy famously offered Latin American nations 'a special pledge--to convert our good words into good deeds--in a new alliance for progress--to assist free men and free governments in casting off the chains of poverty'. See BJ Ford, The Alliance for Progress, (1968) Honors Projects, Paper No. 39, available at http://digitalcommons.iwu.edu/history_honproj/39. See also E Cardoso and A Helwege, Latin America's economy: Diversity, trends and conflicts (MIT Press, 1992).

inspired by the search for a grand formula to overcome the region's persistent lack of development.[8]

By most accounts, the latest development initiative that was launched in Latin America, the Washington Consensus, did not deliver on its promise of bringing prosperity to the region.[9] The shortcomings of this programme were numerous. Some of the reforms prompted by the Washington Consensus, for instance, were based on the view that Latin American institutions—the product of complex social, political and economic arrangements—should be replaced with a universal model synthesized from the experience of industrialized nations.

These shortcomings do not mean that the whole enterprise was a complete failure. With a few exceptions, Latin American countries have made some inroads into improving social and economic conditions for their citizens.[10] Moreover, policymakers learned a crucial lesson from their reform efforts. As one of the architects of the Washington Consensus put it recently, the Latin American experience shows that there are no 'magic

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8 The inclination to pursue grand, over-ambitious reforms seems to be deeply embedded in the Latin American psyche. J Williamson, After the Washington Consensus: Latin American growth and sustainable development, Latin American Financing and the Role of Development Banks, Keynote Speech, Belo Horizonte, Brazil (30 March 2006), available at http://www.iie.com/publications/papers/williamson0306.pdf

9 For a review on the Alliance for Progress, see S Edwards (2009); for an analysis on the Washington Consensus, see D Rodrik, Goodbye Washington Consensus, Hello Washington Confusion? A Review of the World Bank's Economic Growth in the 1990s: Learning from a Decade of Reform, (2006) 44 J ECON LIT 969-83.

10 Although economic turmoil in the midst of the Washington Consensus era led some countries to experiment with centrally coordinated economies under the control of authoritarian populists, most Latin American nations still adhere to a moderate version of capitalism and liberal democracy. This latter group of countries has made some progress in alleviating poverty and improving overall economic conditions. M Reid, The Battle for Latin America's Soul: A fight between democrats and populists, THE ECONOMIST (18 May 2006).

formulas for accelerating growth and eradicating poverty…no shortcuts to the Promised Land of sustainable development and prosperity for all'.[11]

Still, for over a decade and following the guidelines set by the Washington Consensus, policymakers sought to stimulate the growth of capital markets in Latin America through the promotion of a standardized set of formal institutions. An example of this approach in the field of company law was the launching of a legal reform programme that introduced modern Anglo-American corporate governance practices into nations with serious institutional deficiencies.[12] To return to the story mentioned earlier, this may be seen as the equivalent of Sir Bradford Leslie having built a modern 'fixed railway bridge' in 19th century India, instead of the famous Floating Bridge.[13]

The impact of the legal reform project has been at best limited, as suggested by recent empirical data and the complete lack of political opposition by dominant interest groups to the reforms introduced across Latin America. The shortcomings of this reform programme may be linked to several causes, including the failure to distinguish between the form and function of institutions. A central message here, spelled out over the following Chapters, is that this programme did not account for the regional state of

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11 J Williamson (2006). John Williamson framed some of the original policies that made up the development initiative known as the Washington Consensus, a label that he himself used to christen the programme. For a discussion on Mr. Williamson's views on the Washington Consensus, see J Williamson, Williamson versus the Washington Consensus, The Growth Blog (10 December 2008), available at http://www.growthcommissionblog.org/content/williamson-versus-the-washington-consensus

12 D Berkowitz, K Pistor and JF Richard, The transplant effect, (2003) 51 AM J COMP L 1, 163-203.

13 Summoned before the Institution of Civil Engineers in 1878, Sir Bradford Leslie offered the following explanation for his decision not to build a fixed bridge: 'The great expense of a fixed bridge, the lengthened period necessary for its construction over a deep and rapid river, with a shifting bed like the Hooghly…gave the preference to a floating bridge, as this could be more cheaply and expeditiously constructed in the first instance'. Minutes, Vol. 53 (1878) 3.

affairs, particularly with regard to the condition of enforcement infrastructure and prevailing ownership patterns.

This dissertation seeks to improve our understanding of the ways in which institutional reform can promote the development of stock markets in Latin America. To that end, this project draws from different sources including the historical experience of industrialized nations, the available literature on institutional reform, the documented shortcomings of the legal reform programme mentioned above and hand-collected data from several Latin American countries. The resulting analysis suggests that the promotion of stock market development may require strategies different to those set in motion under the legal reform programme mentioned above.

The main contribution of this work is twofold. First, this dissertation brings some nuance to the discussions concerning the challenges faced by Latin American capital markets. A proper understanding of these challenges is essential for policymakers in the region, particularly after the onset of the Latin American Integrated Market (MILA, after its acronym in Spanish). As explained in Chapter VII, MILA has led to the cross-border coordination of regulatory initiatives and enforcement policies between Chile, Colombia and Peru, with Mexico scheduled to join before the end of 2013. This process of increasing coordination has, in turn, created the space for a critical assessment of the Latin American experience with the regulation of listed firms. This dissertation seeks to provide some insights that might be useful towards that end.

Second, this dissertation explores which mechanisms might help overcome the challenges mentioned above, with the ultimate goal of stimulating the growth of Latin American capital markets. The particular mechanisms analysed here are grouped under the term ‘transitional strategies’ for institutional reform. This term refers to institutional arrangements specifically designed to smooth the transition from a financial system that relies mostly on relationship-based exchange to one that can also accommodate arm’s length exchange in the context of capital markets.

Some of the transitional strategies reviewed here include institutional arrangements that may seem unorthodox, such as the use of ‘informal enforcement’ techniques, the temporary reallocation of judicial powers to regulators, and the creation of special listing venues with tailored legal regimes. The main goal of this exercise is to inform future reform efforts in Latin America and, in some cases, to offer potentially novel insights for policymakers in other emerging regions.

For the purposes described above, this dissertation builds up from an abstract account of institutional theory and complementarities in the field of company law and securities regulation, to a diagnosis of some of the particular problems that are present in Chile, Colombia and Peru, and finally to a review of potential solutions to these problems. The entire analysis is divided into seven chapters, as outlined below.

Chapter I describes recent developments that are straining the limits of financial systems in Latin America. Available data indicate that finance in the region relies heavily on banks and is dominated by local family groups. However, sustained growth, changes in industrial patterns, a developing economic union (the Pacific Alliance), stock exchange integration under MILA, sound privatization programmes and a surging middle class are increasing the demand for better functioning stock markets and arm’s length access to finance. I track these developments in Chile, Colombia and Peru. Meeting this demand is essential to sustain the process of economic growth in these countries and may play a role in a regional political struggle between moderate social democracy and radical populism also known as the 'battle for Latin America's soul'.

Chapter II looks at the problem of adverse selection in financial markets in developing countries and analyses how institutions can help mitigate this problem. The term 'institutions', as used here, follows North's definition of 'humanly devised constraints that shape human interaction'. [14] To this effect, serviceable institutions can be used to furnish investors with accurate statements about the financial performance of listed firms and credible assurances about the future behaviour of insiders. This dissertation focuses mainly on the adequate provision of these credible assurances as a means to mitigate the problem of adverse selection in capital markets.

Chapter III looks at how formal institutions, defined here as systems of rules backed up by the state or other official organizations, can work to this effect. Chapter IV undertakes a similar analysis from the perspective of informal institutions, namely, behavioural rules that operate outside of the state-backed or official system. These two Chapters suggest that the strength of a country's institutions may be a powerful indicator of its ability to sustain the complex relations involved in stock market finance. To illustrate this point, Chapters III and IV take measure of the role that both formal and informal institutions could play in supporting stock markets under the particular conditions that are present in Latin American countries.

Chapter V develops a framework that seeks to capture the ways in which formal and informal institutions interact with each other. First, institutions may act as substitutes, as illustrated by the experience of US stock markets before the Great Depression and the

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[14] DC North, Institutions, institutional change and economic performance (1990: Cambridge University Press) 4-5.

more recent use of the Nominated Adviser system in the UK's Alternative Investment Market. In the US, the weakness of formal institutions may have given ground to a system of reputational intermediation—an informal institution—under which underwriters pledged their reputational capital to vouch for the accuracy of their clients' financial statements at the time of an IPO. In the Alternative Investment Market, the policy choice to soften formal listing requirements is accompanied by a system of extended reputational intermediation that forces Nominated Advisers to remain as permanent consultants and supervisors of firms listed on AIM.

Second, there may be important complementarities between formal and informal institutions. The relevant examples here include the enactment of liability rules for reputational intermediaries and the 'naming and shaming' policies adopted in countries such as the United Kingdom, Japan and China. Based on the previous examples, this Chapter suggests that an adequate understanding of the substitution and complementarity effects between institutions is essential to any reform programme intended to promote the development of stock markets in emerging countries.

Chapter VI sets out some of the main contributions of this project. While certain authors suggest that the legal reform efforts launched in Latin America should be redoubled, this Chapter takes a step back in order to analyse some of the central problems present in three Latin American countries. The diagnosis set out in this Chapter points to certain obstacles that may slow down the transition towards a financial system that supports both relationship-based and arm's length exchange in capital markets. In particular, the dominance of local business groups, known as *grupos*, poses significant challenges to the transition to a more balanced financial system that can support active capital markets.

Following this diagnosis and drawing from the available literature on 'second-best institutions' and 'institutional bypass', this Chapter explores the use of transitional strategies that target the specific problems identified in Chile, Colombia and Peru. These particular strategies are defined by their ability to (i) rely on local capabilities as a means to deal with the specific problems that have been identified, (ii) build up a base for future institutional reforms and (iii) reduce the negative economic impact of transition. The main goal of these transitional strategies in the three countries analysed here is to enhance the ability of market participants to rely on formal and informal institutions as a means to overcome adverse selection.

Some of the transitional strategies that are discussed in this Chapter include the use of 'informal enforcement' to enhance reputation-based trading for established firms, 'hybrid enforcement'—under a sort of specialized corporate court administered by regulators—to improve the ability of new firms to provide investors with the assurances they require to overcome adverse selection and a system of 'regulatory dualism' to mitigate political economy problems.[15]

Chapter VII starts with a summary of the main challenges that Latin American capital markets currently face. This final Chapter then focuses on the ways in which an ongoing process of integration between Latin American stock exchanges can help policymakers and regulators overcome some of the challenges identified in this dissertation, including the political economy problem tied to the dominance of the

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[15] RJ Gilson, H Hansmann and M Pargendler, Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the US and the EU', Stanford Law and Economics Olin Working Paper No. 390/2010 http://ssrn.com/abstract=1541226.

grupos. The last part of Chapter VII builds on earlier discussions to analyse potential regulatory reforms that could contribute to the development of the region's capital markets.

Chapter I

Does Latin America need domestic stock markets?

1. Why capital markets?

'Latin America doesn't matter'. This phrase, attributed to Richard Nixon in 1971, captured the spirit of an age in which this large, southern area of the globe was seen as an economic backwater.[16] Attitudes towards the region have certainly changed over the past four decades. The mixed collection of nations that make up Latin America now commands some attention, as illustrated by the intense competition for access to the region's markets.[17] The rapid growth of certain countries in the area has in fact reeled in large amounts of capital from international investors and foreign governments. Despite Latin America's improving fortunes, however, most of its countries still face critical problems. Development indicators in fact show that Latin America lags behind many industrialized and emerging nations.[18] Poverty, inequality and illiteracy are at critical levels throughout the area. Social mobility is despairingly low.[19] Local markets are controlled by a handful of business groups with strong political influence. Corruption and poor fiscal discipline cripple the ability of governments to adequately carry out their functions.

16 F Fukuyama, A quiet revolution: Latin America's unheralded progress, (2007) 86 FOREIGN AFFAIRS 6, 177-182.

17 M Spetalnick, Obama to refocus on Latin America amid Chinese push, REUTERS (16 March 2011).

18 E Perez and R Pineda, Does Latin America lag behind due to sharper recessions and/or slower recoveries, (2010) MPRA Working Paper No. 25036, available at http://mpra.ub.uni-muenchen.de/25036/1/MPRA_paper_25036.pdf

19 V Azevedo and CP Bouillon, Social mobility in Latin America: A review of existing evidence, (2009) Inter-American Development Bank Working Paper No. 689.

The wide-ranging reform programmes mentioned in the introduction were meant to deal with these problems. These programmes had an important economic component that, particularly after the introduction of the Washington Consensus, focused closely on financial development. One of the driving forces behind the Washington Consensus—a program that still has some influence over reform efforts currently underway in Latin America—is the notion that financial development can stimulate economic growth.[20] This idea inspired many reforms, including a corporate governance initiative launched in the region as a means to promote financial development through the expansion of local stock markets.[21]

The notion that financial development has a hand in economic growth, though not new, is certainly controversial. Economists have attempted for decades to improve our understanding of the complex relation between finance and growth.[22] Although the number of experiments that test the strength and direction of the finance-growth nexus has increased significantly over the past decades, mixed results and methodological concerns have kept the issue open to this day.[23]

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[20] The World Bank's 2002 World Development Report explicitly states that financial development 'contributes significantly to growth'. See P Lawrence, Fifty years of financial development: Does causation matter?, (2003) Keele Economic Research Paper No. 7, available at http://www.dfid.gov.uk/r4d/PDF/Outputs/Mis_SPC/R7968a.pdf. For a historical review of the notion of economic growth, see HY Wan, Jr., Economic growth (New York: Harcourt, Brace, Jovanovic, 1971) 4-6.

[21] For a detailed explanation of the different components that made up the Washington Consensus and its 'augmented' version, see D Rodrik, Goodbye Washington Consensus, hello Washington confusion? A review of the World Bank's Economic Growth in the 1990's, (2006) 47 J ECON LIT 973.

[22] See Section 2 for a review of the literature produced on this topic.

[23] F Allen and others, How important historically were financial systems for growth in the UK, US, Germany and Japan?, (2010) Working Paper, available at http://fic.wharton.upenn.edu/fic/papers/10/10-27.PDF and R Levine, 'Finance and growth: Theory and evidence' in Handbook of economic growth (P Aghion and SN Durlauf eds, Elsevier, 2005).

There are now countless studies that identify the channels through which financial systems can potentially influence economic growth. The main lines of research focus on the role that banks and stock markets can play in facilitating the expansion of a country's economy. The evidence gathered to this effect highlights the pros and cons of 'bank-based' and 'market-based' financial systems—two notions that are defined in detail below— in supporting economic growth.[24] The growing consensus in this field revolves around the idea that the ability of financial systems to provide certain essential services may be central to sustain economic growth.[25] In turn, the ability of financial systems to provide these services in any given country is thought to depend on a number of factors, including the level of economic development and the compatibility between a nation's financial system and local conditions.[26]

The discussion above leads into some questions about the emphasis that has been placed on the development of stock markets in Latin America. Is better support for market-based finance essential for economic growth in the region?[27] Can all Latin American countries support active capital markets?[28]

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24 A Demirgüç-Kunt and others, The evolving importance of banks and securities markets, (2011) World Bank Policy Research Working Paper No. 5805; T Beck, Stock markets, banks and economic development: Theory and evidence, (2003) 7 EIB PAPERS 2, 36-54; BS Black and RJ Gilson, Venture capital and the structure of capital markets: Banks versus stock markets, (1998) 47 J FINAN ECON 243.

25 R Levine (2005) 919.

26 A Demirgüç-Kunt and others (2011).

27 A team led by A de la Torre at the World Bank has provided some insights into answering this question. The arguments set out in this work is analysed in some detail throughout this Chapter. See A de la Torre and others, Financial development in Latin America and the Caribbean: The road ahead, (World Bank, 2012); A de la Torre and SL Schmulker, Emerging capital markets and globalization: The Latin American experience (Stanford University Press, 2007).

28 It has been argued that many economies in the area are too small to support liquid stock markets, a situation that is only made worse by the fact that Latin American firms are increasingly migrating to international markets. A de la Torre and SL Schmulker (2007).

This Chapter addresses the question of whether or not the promotion of domestic stock markets is a sound policy objective for Latin American nations. The discussions below will first attempt to throw some light on the way in which financial systems operate in the region. This exercise will then be followed by an analysis concerning the degree to which Latin American financial systems match the area's economic fundamentals.

2. Financial development and economic growth

The attention of economists has long been drawn to a deceivingly simple question: Do the services provided by the financial system facilitate a nation's economic growth? As early as 1873, Walter Bagehot described how developments in the financial sector had contributed to the unprecedented level of industrial expansion in 19th century England.[29] In his words, 'we have entirely lost the idea that any undertaking likely to pay, and seen to be likely, can perish for lack of money (…). Thus English capital runs as surely and instantly where it is most wanted, and where there is most to be made of it, as water runs to find its level'.[30]

Joseph Schumpeter developed this idea further by pointing out that the financial industry allowed for the efficient reallocation of capital, which ultimately favours economic growth.[31] Since then, economists have worked out numerous theoretical

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29 F Allen, SC Myers and RA Brealey, Principles of corporate finance (8th ed., McGraw-Hill, 2006) 946 ('railways were first developed in the United Kingdom in the nineteenth century, financed largely through the London Stock Exchange').

30 W Bagehot, Lombard Street: A description of the money market, (A W Wright, London, 1915) 7-13.

31 See J Schumpeter, A theory of economic development, (Harvard University Press, 1934). See also RG Rajan and L Zingales, Financial dependence and growth, (1998) 88 AMER ECON REV 3, 559-586.

models and empirical studies designed to test the idea that financial development has a hand in the growth of nations.

A large portion of the literature produced over the past few decades has found that there is a positive correlation between financial development and economic growth.[32] For example, a cross-country study found a strong relation between several measures of economic growth and both the size of intermediaries relative to GDP and the ratio of credit issued to private firms relative to GDP, two key indicators of financial development.[33] Another paper contributed evidence about the positive correlation between stock market development and overall growth.[34] This last finding was reinforced by another study that used data from 47 countries to suggest the existence of a correlation between stock market liquidity and the rate of economic growth.[35] Countless other studies have produced similar results using an assortment of different methods.[36]

Although economists mostly agree about the strong relation between finance and growth, there is still some dispute concerning the direction of causality between the two.[37] A host of empirical analyses, including the ones cited above, suggest that the expansion of stock markets and the banking sector predicts the growth of an economy

32 For a comprehensive review of this literature, see R Levine (2005).

33 RG King and R Levine, Finance and growth: Schumpeter might be right, (1993) 108 Q J ECON 3, 717-737.

34 R Atje and B Jovanovic, Stock markets and development, (1993) 37 EUROP ECON REV, 632-640.

35 R Levine and S Zervos, Stock markets, banks and economic growth, (1998) 88 AMER ECON REV 3. This study also found that several measures of banking sector development were correlated with economic growth.

36 A Demirgüç-Kunt and others (2011); R Levine (2005); RK Filer, J Hanousek and NF Campos, Do stock markets promote economic growth, (2000) CERGE-EI Working Paper No. 151, available at http://ssrn.com/abstract=1535900; R Levine (1997).

37 R Levine and S Zervos (1998) 537-558.

with some accuracy.[38] These studies have been used to support the idea that financial systems exert a positive influence on growth.[39] Critics of this view argue that a country's financial infrastructure develops mostly in response to entrepreneurial needs, a position best captured by Joan Robinson's contention that 'by and large, it seems to be the case that where enterprise leads, finance follows'.[40] Some authors take the more eclectic view that there is a degree of co-evolution between financial development and economic growth.[41]

Even though there is still much room for debate, there is some evidence that suggests that financial systems can stimulate economic growth through a number of channels.[42] The first part of this Section takes measure of these channels under the assumption that finance can in fact *facilitate* the process of economic development, without being the only driver of growth.[43] To be sure, the discussions presented here do not imply that alternative views of the finance-growth nexus are irrelevant or inaccurate. In fact, as explained further below, economic growth can also influence the development of financial systems.[44] By looking at both sides of a complex relationship, the following

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38 R Levine, Financial development and economic growth: Views and agenda, (1997) 35 J ECON LIT 2, 688-726.

39 'The preponderance of the evidence suggests that both financial intermediaries and markets matter for growth…theory and empirical evidence make it difficult to conclude that the financial system merely–and automatically–responds to economic activity, or that financial development is an inconsequential addendum to the process of economic growth'. R Levine (2005) 921.

40 J Robinson, The Generalisation of the General Theory in 'The Rate of Interest and other Essays' (London: MacMillan & Co Ltd 1952) 86.

41 For a summary of the studies that support this view, see P Lawrence (2003). See also R Levine (2005) 922.

42 C Mayer, Trust in financial markets, (2008) 14 EUROP FIN MAN 4, 617-632.

43 This view follows RG Rajan and L Zingales (1998), who 'find evidence of finance as a lubricant, essential no doubt, but no substitute for the machine' (561). See also C Mayer (2008) and F Allen, SC Myers and RA Brealey (2006) 945.

44 A Demirgüç-Kunt and others (2011).

discussions provide some insight into the questions posed in the introduction to this Chapter.

A. Financial services and economic growth

The importance of finance is said to lie with the services that it supplies to economic actors.[45] Well-functioning financial systems are thought to facilitate market interactions between these actors, a process that has a positive effect on indicators of long-run growth.[46] For instance, a financial infrastructure that enhances access to external capital will fuel the expansion of industrial sectors that have limited recourse to internal funds and create space for the growth of new undertakings.[47] Financial systems can also enhance the process of gathering and disseminating information about firms, which may ultimately improve overall resource allocation. The degree to which the component organizations of financial systems are able to provide services such as these is one potential measure of a country's level of financial development.

With these considerations in mind, the discussions below set out some of the main services performed by financial systems, with a brief discussion of how these services can stimulate economic growth.[48] The following analysis also takes into account a few of

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45 'The job of financial systems is to efficiently create financial liquidity for those investment projects that promise the highest profitability and that maximize collective utility'. P Vernimmen and others, Corporate finance: Theory and practice (6th ed, West Sussex: John Wiley & Sons, 2005) 268.

46 R Levine (2005).

47 RG Rajan and L Zingales (1998).

48 The taxonomy of financial functions used here follows R Levine (2005) and F Allen, The Efficiency and Stability of Banks and Markets, (2004) National Bank of Belgium Working Paper No. 52.

the ways in which banks and stock markets, the two main components of financial systems, can provide these services to economic agents.

(i) Access to external finance

Perhaps the most familiar function attributed to the financial industry is the provision of external finance for commercial and industrial undertakings.[49] Firms can obtain the capital required to conduct their activities from a variety of sources. In the initial stages of a company's life cycle, entrepreneurs can pool their own resources along with those of individuals with whom they share business interests or bonds of family and friendship.[50] As this initial inflow of capital is often limited in nature, the firm's continuing operations may have to rely on other sources of finance. In many cases, a firm can resort to internally generated funds in order to meet its financing needs.[51] More often than not, however, firms will require external sources of finance in order to raise the capital needed to cover operational expenses and to fund further expansion.[52]

Financial systems have a hand in the process of agglomerating the funds of multiple third parties and channelling them into firms with financial needs.[53] The banking sector can perform this function by lending out a portion of the funds deposited by their

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49 C Mayer (2008).

50 R Cooter and HB Schäfer, Solomon's knot: Law's role in ending the poverty of nations, (2010) German Working Paper in Law and Economics No. 7.

51 Internal finance 'constitutes the dominant source of finance' for firms across most countries. See J Tirole, The theory of corporate finance, (Princeton University Press, 2006) 96. See also F Allen, SC Myers and RA Brealey (2006) 363.

52 J Tirole The theory of corporate finance, (Princeton University Press, 2006) 96-97.

53 V Fitzgerald, Financial development and economic growth: A critical view, (2006) World Economic and Social Survey, available at www.un.org/esa/policy/backgroundpapers/fitzgerald_draft.pdf

customers.[54] This is accomplished through a system in which 'thousands of investors entrust their wealth to intermediaries that invest in thousands of firms'.[55] In turn, capital markets create a specialized forum where firms, analysts and investors can interact to mobilize large amounts of resources.[56]

In both cases, the financial system enlarges the flow of capital that is available to firms.[57] This increase in the rate of physical capital accumulation can have a positive impact on economic growth.[58] In particular, the availability of external resources may boost the expansion of industries that rely heavily on this form of finance, as well as fund the development of new firms that would otherwise lack the capital required to fund their growth.[59]

(ii) Information content of potential investments

Aside from the pooling function described above, financial systems have a hand in enhancing the information content of potential investments, which may improve the allocation of resources in an economy.[60]

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54 R Inklaar and M Koetter, Financial dependence and industry growth in Europe: Better banks and higher productivity, (2008) Groningen University Research No. 100, available at http://ideas.repec.org/p/dgr/rugggd/gd-100.html

55 R Levine (2005) 879.

56 Tirole identifies four stages of equity finance, which range from shares being held by a few entrepreneurs to seasoned public offerings. See J Tirole (2006).

57 P Vernimmen and others (2005) 269.

58 RG King and R Levine (1993) 734-735.

59 RG Rajan and L Zingales (1998).

60 It has been argued that the efficient allocation of resources, and not the mere aggregation of capital, may be the main driver of economic growth. R Levine (2005) 870. For a review of the relevant literature, see A Bonfiglioli, Financial integration, productivity and capital accumulation, (2007) 76 J INT ECON 2, 337-355. See also S Kleimeier and R Vertseeg, Project finance as a driver of economic growth in low-income countries, (2009) Maastricht University Working Paper No. 011 and V Fitzgerald (2006) 3.

The decision to invest in a business project can entail significant costs.[61] Before deciding whether or not to contribute funds to a specific undertaking, investors must sort through countless investment opportunities. For each potential investment, these parties must process information about prevailing economic conditions, the firm's future prospects and the abilities of its managerial team.[62] The potentially high costs of gathering and analysing this information may deter investors from allocating their resources to the projects in which these funds will be most efficiently deployed.[63]

The financial system provides a bundle of solutions to this problem.[64] Banks and other organizations take advantage of economies of scale to conduct research on investment opportunities. Whilst some banks process firm data to determine whether or not to provide loans to potential borrowers, other financial intermediaries may sell the processed information directly to investors.[65] Stock markets can also improve the dissemination of high quality information through the collective processing power of a large pool of financial analysts.[66]

It follows that financial systems not only reduce the cost of gathering and analysing data, but also improve the overall quality of available information. As a result, financial systems may allow investors to identify the best investment opportunities,

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61 EW Davis and J Pointon, Finance and the firm: An introduction to corporate finance (2nd ed., Oxford University Press, 1994).

62 A de la Torre and SL Schmulker (2007) 5.

63 R Levine (2005) 870.

64 F Allen (2004).

65 R Levine (2005) 871.

66 D Easley and M O'Hara, 'Information and the Cost of Capital' (2004) 59 J FIN 1573.

which improves the efficiency of resource allocation, since capital will flow to the places in which it will be most productive.[67]

The information-processing role of financial systems also enhances the prospects for technological innovation, as investors will be able to identify the most promising new products and services and organization techniques.[68] It is important to bear in mind, however, that banks and stock markets may favour different types of innovation.[69] As explained more thoroughly in the next Section, banks may be better at supporting 'incremental' innovation, while stock markets seem better equipped to support 'revolutionary' innovation processes.[70]

(iii) Monitoring and disciplining firms

Financial systems can also have important effects on the allocation of resources within firms. When the insiders of a company (i.e. managers or controlling shareholders) have a free rein to conduct the firm's affairs, they might decide to increase their own wealth at the expense of firm value.[71] This not only reduces the efficiency with which

[67] See also F Allen, SC Myers and RA Brealey (2006) 945 ('widely available credit information reduces the cost of lending and increases the availability of credit').

[68] Technological innovation is thought to be essential for long-run economic growth. R Levine (2005) 871

[69] Z Bodie and RC Merton, Design of financial systems: Towards a synthesis of function and structure, (2004) Harvard Business School Working Paper No. 074 available at http://ssrn.com/abstract=313651.

[70] The orientation of the financial system is one of the elements that may give rise to a comparative advantage between economic systems, as explained in the Varieties of Capitalism literature. See P Hall and D Soskice, 'An introduction to varieties of capitalism' in Varieties of capitalism: The institutional foundations of comparative advantage (P Hall and D Soskice, eds, OUP 2011); P Hall and D Gingerich, Varieties of capitalism and institutional complementarities in the political economy: An empirical analysis, (2009) 39 BRIT J POL SC 449.

[71] This assertion is related to the theory of agency, which will be discussed in further detail in Chapter II.

resources are allocated within companies, but can also impair the willingness of investors to fund commercial and industrial undertakings.[72]

A country's financial system has different ways of providing solutions to this problem.[73] For instance, banks may keep a close watch on the financial performance of firms who have been recipients of loans, which could exert pressure on insiders to maximize firm value.[74] A similar monitoring function is usually attributed to institutional investors and other outside shareholders in listed firms.[75] Also, the market for corporate control—a feature of a few mature stock markets with a visible degree of ownership dispersion—can move insiders to act in the best interests of the firm.[76] As a result of these functions, financial systems can enhance the allocation of resources within firms, with positive consequences for economic growth.

(iv) Reduction of risk

Financial systems also supply important services with regard to the risk management strategies of investors and entrepreneurs. Banks and stock markets allow these parties to spread out their risk exposure across several firms and industrial sectors.[77] By holding a large equity stake in a single company, investors become particularly

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72 R Levine (2005) 872.

73 For a discussion of the different ways in which this can happen, see R Levine (2005) 872.

74 T Sokolyk, Do banks reduce information asymmetry and monitor firm performance? Evidence from bank loans to IPO firms, (2009) University of Wyoming Working Paper.

75 A Danis, Shareholder monitoring and risk sharing, (2010) Vienna School of Finance Working Paper.

76 HG Manne, Mergers and the market for corporate control (1965) 73 J POL ECON 2, 110-120.

77 BA Ødegaard, 'The Diversification Cost of Large, Concentrated Equity Stakes. How Big Is It? Is It Justified?' (2009) 6 FRL 56, 72; A Shleifer and RW Vishny, 'A Survey of Corporate Governance' (1997) 52 J FINANCE 737, 783; H Demsetz and K Lehn, 'The Structure of Corporate Ownership: Causes and Consequences' (1985) 93 J POLIT ECONOMY 1155, 1177.

vulnerable to firm-specific risks of a non-systemic nature. If, for instance, the industry in which a company operates is in the midst of a recession, a shareholder with a significant stake in the firm will bear much of the resulting loss. Accordingly, well-diversified investors are at less risk of loss than those who hold of shares in a single firm.[78]

The financial industry also facilitates portfolio diversification, a process that involves the pooling of investments in undertakings with different risk profiles. Portfolio diversification allows investors to participate in high-risk projects that would otherwise lack the large initial investments they require to take off.[79] This function of financial systems allows funds to flow to innovative activities, which may have a positive impact on economic growth.[80]

Another important service tied to the financial industry concerns the amelioration of liquidity risks. Investors place a high value on the liquidity that can be obtained when they sell an investment from their equity portfolios.[81] This holds true for the many different parties that can hold equity stakes in a firm, including founders, employees, venture capital funds and institutional investors. The availability of a secure exit strategy is of such importance that in some cases it can make or break the commitment of prospective investors to contribute human and capital resources to a fledging enterprise.[82]

To this effect, financial systems have different ways of granting investors a measure of liquidity. Banks that pool savings offer their deposit-holders immediate

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78 A Bodnaruk and others, 'Shareholder Diversification and the Decision to Go Public' (2008) 21 REV FINAN STUD 2779, 2824.

79 R Levine (2005).

80 RG King and R Levine (1993)

81 G Smith, The exit structure of venture capital, (2005) 53 UCLA L REV 53.

82 BS Black and RJ Gilson (1998).

liquidity, whilst at the same time channelling these savings to illiquid, long-term projects.[83] Stock markets allow investors to sell their stake in similar projects at a low cost through secondary trading. In both cases, the financial system facilitates the development of long-term undertakings by granting potential investors their required levels of liquidity, which, once again, may stimulate economic growth.[84]

B. The 'architecture' of financial systems

As illustrated above, the importance of the financial industry seems to be tied to the growth-enhancing services that it provides to a nation's economic actors. The nature and availability of these services may vary depending on the mix of organizations (i.e. banks and stock markets) and mechanisms (i.e. relationship-based and arm's length interactions) that support financial systems. The mix of organizations and mechanisms makes up the 'architecture' of a country's financial system. This 'architecture' can differ considerably across jurisdictions.

Many authors divide financial systems into bank-based or market-based, two highly stylized categories based on the *type of organization* that weighs more heavily in providing financial services to a nation's economy.[85] Continental European countries have traditionally been assigned to the bank-based category, due to the large role that the eponymous organizations have in providing the financial services that support economic

83 R Levine (2005) 878; F Allen (2004).

84 R Levine (2005) 879.

85 OE Ergungor, Financial system structure and economic growth: Structure matters, (2008) 17 INT REV FIN ECON 292-305; T Beck and R Levine, Stock markets, banks and growth: Panel Evidence, (2004) 28 J Banking Finance 3, 423-442.

growth across these nations.[86] In contrast, the United States and the United Kingdom are considered to be strongly reliant on market-based finance.[87]

Financial systems can also be classified according to the *nature of the mechanisms* that sustain financial ties between different economic agents. Under this taxonomy, relationship-based finance refers to associations made possible by repeat dealings and self-governing arrangements.[88] Finance of this nature relies mostly on close ties between the providers and the recipients of financial services, both of which will have an interest in abiding by the terms of their ongoing relationship without necessarily relying on legal or contractual protection to force compliance.[89] To substitute for this protection, economic agents rely on the prospect of future dealings as a measure to ensure compliance with the terms of their relation.[90] A breach by one of the parties will cause the other party to negatively readjust the terms of their relationship or even to terminate it. For this reason, both parties may have incentives to deal fairly with each other as long as the expected future payoffs of 'cooperation' (i.e. compliance with their mutual understandings) are higher than the immediate payoff of 'defection' (i.e. breach of their mutual understandings).[91]

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86 F Allen and others (2010).

87 T Beck (2003).

88 R Rajan and L Zingales, Banks and markets: The changing character of European finance, (2003) NBER Working Paper No. 9595.

89 R Gil and J Marion, 'The Role of Repeated Interactions, Self-enforcing Agreements and Relational (sub) Contracting: Evidence from California Highway Procurement Auctions', University of California Working paper 2009 http://people.ucsc.edu/~rgil/Gil_Marion_Oct09.pdf;

90 BR Cheffins Corporate Ownership and Control: British Business Transformed (OUP, Oxford 2008).

91 For a more thorough explanation of relationship-based trading and repeat interactions, see Chapter IV.

It follows that relationship-based finance may be limited in scope, as it relies on the prospect of repeat dealings between counterparties.[92] Even in the presence of repeat dealings, economic actors will have incentives to defect on their commitments to each other as the 'end period' in their relationship approaches. However, the introduction of certain elements can extend the scope of relationship-based finance. For instance, the 'reputation' of parties can play an important role in allowing firms to deal with multiple counterparties without the need for repeat interactions. 'Reputation' can also reduce the incentives for defection if market participants can observe instances of unfair dealing, which may lead them to react negatively against the parties that defected. Chapter IV explores these ideas in more detail.

'Arm's length finance', on the other hand, involves impersonal exchange based on explicit agreements (i.e. contracts, legal rules).[93] Economic actors will only enter into relations of this nature if they can fall back on the protection afforded by the enforcement of these explicit agreements, which suggests that effective legal systems are a prerequisite for a country to sustain arm's length finance.[94] As relations of this nature do not rely on repeat dealings or the reputation of contracting parties, arm's length finance is not subject to the limits that constrain the scope of relationship-based finance.[95] However, as

92 'Relational contracting narrows the scale of cooperation, reduces competition, and fails altogether in one-time transactions or high-value transactions'. R Cooter and HB Schäfer (2007) 138. See also RJ Gilson and C Milhaupt, Economically Benevolent Dictators: Lessons for Developing Democracies, (2011) 59 AMER J COMP L 1.

93 R Rajan and L Zingales (2003).

94 F Allen, X Gu and O Kowalewski, Financial crisis, structure and reform, (2011) Working Paper No. 37, available at http://fic.wharton.upenn.edu/fic/papers/11/p1137.htm

95 RJ Gilson, Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange, (2007) 60 STAN L REV 636.

explained in Chapters III and VI, setting up and operating a system that can effectively enforce legal rules and contractual provisions is not an easy task.

There are close links between the type of organizations (i.e. banks and stock markets) and the nature of the mechanisms (i.e. relationship-based and arm's length interactions) that make up financial systems.[96]

Banks are often the main source of financial services where relationship-based finance is dominant. Since relationship-based interactions do not require enforceable explicit agreements, finance of this nature is usually dominant in countries with defective legal systems. In countries that fit this description, incomplete enforcement may lead to a setting with a scarcity of publicly disclosed information about firms and weak formal protection of financiers. The ability of banks to invest in long-term relations with firms allows them to gather information in these low-disclosure environments and to properly determine the terms under which they will provide finance to their clients.[97] As these long-term relations involve repeat dealings, they activate the mechanism that allows banks and client firms to deal with each other without effective legal or contractual protection.

However, relationship-based finance may be limited in its ability to sustain the complex relations that arise in stock markets between a firm and multiple outside shareholders.[98] It may in fact be difficult for these investors to gather accurate information about issuing firms in the absence of properly enforced rules for mandatory

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96 R Rajan and L Zingales (2003).

97 AW Boot, Relationship banking: What do we know? (2000) 9 J FINAN INTERMEDIATION, 7-25.

98 R Rajan and L Zingales (2003).

disclosure.[99] In addition, outside shareholders with short to mid-term investment horizons will find it harder than banks to rely on repeat dealings as a substitute for legal protection. It follows that arm's length interactions—which allow outside investors to obtain disclosure and protection from enforceable explicit agreements—may be better suited than relationship-based finance to support stock markets.[100]

It is important to bear in mind, however, that the links between relationship-based systems and banks, and between arm's length finance and stock markets, do not mean that alternative pairings between them are incompatible.

The banking industry can dominate the financial system even in nations with support for arm's length interactions, as it has traditionally been the case in Germany and Japan.[101] At the same time, the venture capital industry in the United States, which has a strong component of relationship-based finance, relies to a large extent on this country's mature stock market to function properly.[102] Moreover, as explained in Chapter IV, stock markets can operate in nations that do not fully support arm's length interactions, where relationship-based trading can provide a partial substitute for enforceable explicit arrangements.[103]

With the previous observations in mind, the following discussions inquire into the relation between the 'architecture' (i.e. the mix of organizations and mechanisms

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99 MB Fox, Retaining mandatory securities disclosure: Why issuer choice is not investor empowerment, (1999) 85 VIRG L REV 7.

100 OE Ergungor (2008); KB Luintel and others, Financial structure and economic growth, (2008) Cardiff Economics Working Paper No. 3.

101 Y Yafeh and O Yosha, Industrial organization of financial systems and strategic use of relationship banking, (2001) 5 EUROP FIN REV 63-78.

102 R Rajan and L Zingales (2003); BS Black and RJ Gilson (1998).

103 A Gomes, Going Public Without Governance: Managerial Reputation Effects, (2000) 55 J FINANCE 634.

described above) of a nation's financial systems and some of its main macroeconomic features.

(i) Financial 'architecture' and macroeconomic features

The starting point for this analysis is the idea that financial systems can produce different outcomes depending on their 'architecture'.[104] For instance, banks may be more suitable than stock markets to support 'shorter-run, lower-risk, well-collateralized endeavours', while stock markets may have an advantage in supporting 'longer-run, higher-risk projects that rely on more intangible outputs'.[105]

Although differences of this nature have given currency to a debate on whether one system is inherently superior to the other, there seems to be some agreement on the idea that heterogeneous financial configurations can potentially achieve similar results in facilitating economic growth.[106] The historical experience of developed countries seems to bear out this point. In fact, industrialized nations such as the United States, the United Kingdom, Germany and Japan achieved comparable levels of growth with substantially different financial systems.[107]

The lack of a universal recipe to organize a nation's financial industry does not mean, however, that financial 'architecture' is irrelevant for economic growth.[108] The particular mix of organizations and mechanisms in a financial system determines the

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104 R Rajan and L Zingales (2003)

105 A Demirgüç-Kunt and others (2011).

106 'There is not one optimal institutional structure for providing growth-enhancing financial functions to the economy'. R Levine (2005) 919. For discussions on the bank-based versus market-based debate, see T Beck (2003).

107 F Allen and others, (2010).

108 A Demirgüç-Kunt, Finance and economic development: Policy choices for developing countries, (2006) World Bank Policy Research Working Paper No. 3955.

nature of the financial services that are available to support a nation's economy. In turn, the demand for financial services of a certain nature might vary depending on its particular macroeconomic features, including industrial structure, the nature of innovation processes and the size of the economy.[109] This points to the correspondence between a nation's financial architecture and its macroeconomic features as one of the factors that have an influence on economic growth.[110] In other words, economic activity may be promoted when the services supplied by the financial system (as determined by the system's 'architecture') match the demands of a nation's economy (as determined by the nation's macroeconomic features).[111]

It is important to note at this point that the relation between financial systems and macroeconomic variables is highly complex. For instance, the demand for financial services of a certain nature can change over time, depending on the stage of a country's economic development.[112] One recent study suggests that, as a country develops, the demand for the financial services supplied by stock markets increases 'relative to the demand for those [services] provided by banks'.[113] Moreover, the relation between financial 'architecture' and macroeconomic variables is often bi-directional. To this effect, the development of high-tech industries that demand external finance can exert pressure on the financial system to support the provision of equity investments which, if

[109] A Demirgüç-Kunt and others (2011) ('economies at different stages of economic development require different mixtures of these financial services to operate effectively) 2.

[110] This observation is related to the notion of *complementarity* used in the Varieties of Capitalism literature, as explained more thoroughly in Chapter V. P Hall and D Soskice (2011).

[111] A Demirgüç-Kunt and others (2011) (finding that 'deviations of an economy's actual financial structure from its estimated optimum' are tied to 'a reduction in economic output') 4. See also F Allen, L Bartiloro and O Kowalewski, Does economic structure determine financial structure? (2007) AFA Chicago Meetings Paper; R Rajan and L Zingales (2003).

[112] A Demirgüç-Kunt and others (2011).

[113] Id. at 4.

accomplished, may in turn increase the size of the industries that demand external equity finance.

This Chapter does not seek to exhaustively analyse the relation between financial systems and macroeconomic features.[114] It rather looks at some potential ways of assessing the correspondence between the supply and demand of financial services, as a means to improve our understanding of how financial systems may contribute to economic growth.[115] The following paragraphs work towards this end.

—Firm size

One variable that might be relevant to assess the match between the supply and demand of financial services is the size of the firms that operate in a given jurisdiction. Bank-based systems may be better suited than market-based systems to supply the financial services required by economies in which small firms are dominant.[116] This match between bank-based finance and small companies has been attributed—at least in part—to the high cost of accessing capital markets, which place equity finance well beyond the reach of most firms.[117] As only the largest firms in a given jurisdiction will

114 There is an unsettled debate between the proponents of the idea that a country's economic structure determines the internal configuration of its financial system and those who hold that causation runs in the opposite direction. This Section does not seek to take part in this debate but rather to isolate and examine one dimension of the complex nexus between finance and economic development. Accordingly, the discussions here only take stock of some of the ways in which financial 'architecture' may be suited to match a nation's economic background. This exercise sets the stage for the analysis of Latin American financial systems that is the subject of the next section. For an analysis on the direction of causality between the internal configuration of financial systems and economic structure, see F Allen, L Bartiloro and O Kowalewski (2007).

115 D Rodrik, One economics, many recipes: Globalization, institutions and economic growth (Princeton University Press, 2007); S Tadesse, Financial architecture and economic performance: International evidence, (2002) 11 J FINAN INTERMEDIATION 429-454.

116 S Tadesse (2002).

117 AN Licht, Cross-Listing and Corporate Governance: Bonding or Avoiding?, (2003) 4 CHIC J INT L 141.

have the resources to profit from market-based finance, most companies will be heavily reliant on the banking industry to carry on their operations.[118] It follows that in an economy composed mostly of small and mid-size firms, a system tilted towards bank finance may be well suited to provide the financial services required by domestic firms.[119]

—Industrial structure

Another way of ascertaining the degree to which a financial system matches the demand for financial services involves the nature of the assets that support the operation of the local economy. The exploitation of intangible assets is often carried out by high technology and knowledge-based industries, which are riskier than more traditional industries that rely mostly on physical assets.[120] This distinction may grant an advantage to arm's length, market-based systems in providing financial services to industrial sectors that exploit intangible assets, as the public flow of information about the firm's prospects facilitates investment decisions in this context.[121] Conversely, investments in firms that are physical-asset-intensive are less dependent on 'market signals about their profitability', which makes this asset class compatible with relationship-based, bank-oriented systems.[122] The ability of firms to use their physical assets as collateral also

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[118] It is also relevant to note that large multi-layered firms are better able than their smaller counterparts to produce information in the amount and quality required for the operation of market-based finance. R Rajan and L Zingales (2003) 20.

[119] S Tadesse (2002).

[120] R Rajan and L Zingales, Financial systems, industrial structure and growth, (2001) 17 OXFORD REV ECON POL 4, 476.

[121] C Mayer (2008); F Allen, L Bartiloro and O Kowalewski (2007).

[122] R Rajan and L Zingales (2003) 19.

enhances their ability to negotiate with potential financiers in bank-oriented systems.[123] This may reinforce the match between a financial system dominated by banks and industries that are physical-asset-intensive.[124]

Moreover, the lack of publicly available information about a firm's profitability in relationship-based systems dominated by banks may create a sterile environment for high technology and knowledge-based industries. In financial systems of this nature, financial intermediaries may have a monopoly on the information produced by firms that operate in high technology and knowledge-based industries, which will allow these intermediaries to demand significant rents in exchange for the provision of financial services.[125] This may reduce the incentives for firms to deploy their human capital in undertakings with a high level of risk such as those prevalent in technology and knowledge-based industries. This problem is not as acute across firms that exploit fixed assets, since these companies usually belong to more traditional industries that are 'well understood'.[126]

—Innovation processes

The nature of innovation processes may also be relevant to the analysis presented here. While relationship-based systems tilted towards bank finance are well suited for innovation of an incremental nature, arm's length, market-based systems have a comparative advantage with regard to revolutionary innovation processes.[127] This

123 F Allen, L Bartiloro and O Kowalewski (2007).

124 KB Luintel and others (2008) 10; F Allen, L Bartiloro and O Kowalewski (2007).

125 R Rajan and L Zingales (2001) 476.

126 R Rajan and L Zingales (2003) 19.

127 F Allen, L Bartiloro and O Kowalewski (2007).

difference is mainly due to the way in which information is disseminated in each system. As mentioned above, financial intermediaries may have an information monopoly over their client firms in relationship-based, bank-oriented systems. The decision about whether or not to provide funding for the development of new technologies will therefore rest on a reduced number of tightly coordinated financiers. In this setting, banks are able to conduct thorough screening processes before providing the capital required by firms with potential innovations. This favours the safer path of incremental innovation through the 'minor modification of tried and tested technologies' over revolutionary innovation, which usually involves funding multiple failed ventures.[128]

In arm's length, market-based systems, information about new technologies reaches multiple potential investors, who conduct separate inquiries based on their own idiosyncrasies and often with incomplete information.[129] The large number of prospective investors and of uncoordinated and potentially fragmentary screenings increases the chances that firms will obtain the funding necessary to invest in many innovative projects. Although this process will channel resources to many ventures ultimately bound for failure, it also allows for revolutionary innovation to take place.

Moreover, as explained further on, the wide dissemination of information in market-based systems favours the emergence of newcomer firms, which are more likely than incumbents to develop technologies that disrupt existing markets or create new ones.[130] This stands in contrast to relationship-based, bank-oriented systems, where newcomers often have a hard time meeting their financing needs. Financial

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128 R Rajan and L Zingales (2003) 21.

129 Id.

130 I Mahmood and W Mitchell, Two faces: Effects of business groups on innovation in emerging economies, (2004) 50 MANAGEMENT SCIENCE 10, 1351.

intermediaries in systems of this nature have incentives to preserve the profitability of their incumbent clients, which may be eroded if new competitors arise to challenge them.[131] The flow of resources away from newcomers and into incumbent firms enhances the prospects for incremental innovation in systems tilted towards bank finance.

—Size of the economy

The size of the economy also has some bearing to determine the degree of affinity between financial systems and local macroeconomic conditions. Small economies in which industrial diversity is scarce provide fertile ground for repeated interactions between a limited numbers of players and allow banks to capitalize on their ability to forge close, long-term relations with clients.[132] Arm's length market-based systems are more compatible with large, diverse economies in which price signals allow for the efficient reallocation of resources.[133]

(ii) The problem of transition to a 'mixed' financial system

It must be noted again that the previous efforts to dissect financial systems are merely heuristic in nature. As explained earlier, finance mostly functions through a combination of the organizations and the mechanisms explained above, so that, for instance, no system is purely relationship-based or operates exclusively through stock

131 F Allen, SC Myers and RA Brealey (2006) 947. See also Section 3 below.

132 R Rajan and L Zingales (2003) 27.

133 Aside from the previous criteria, there are many other factors that might be used to measure the 'fit' of a financial system within a particular jurisdiction, such as the liquidity requirements of investors, the nature of the judiciary and the system's ability to match local financing needs. For a review of these factors, see F Allen, L Bartiloro and O Kowalewski (2007), R Rajan and L Zingales (2003) and S Tadesse (2002).

markets. It is also true, however, that financial systems can be particularly reliant on certain organizations or mechanisms. An example of this trend may be seen amongst emerging nations, in which finance has traditionally been relationship-based and dominated by banks.[134] Following the discussions above, a system of this nature is likely to match the particular conditions that are present in developing countries, namely, weak legal systems, a preponderance of small firms, fixed-asset-intensive industries, incremental innovation processes, and small, homogenous economies.[135] Although emerging countries can also support a certain degree of arm's length interactions and exchange through capital markets, the lion's share of finance is usually not conducted through these channels.[136]

During the process of development, a number of factors may bring about changes that generate a mismatch between a country's economic fundamentals and its financial system.[137] When this occurs, there may be an increase in the demand for financial services based on both arm's length and market-based interactions. If the financial system fails to meet this demand, the process of economic growth may be held back.[138] However, the transition from a system tilted toward relationships and bank finance to one with a more balanced mixed of mechanisms and institutions seldom runs smoothly. For this to happen, at least two main obstacles must be overcome.

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134 A Demirgüç-Kunt and R Levine, Bank-Based and Market-Based Financial Systems: Cross-country Comparisons (1999) World Bank Policy Working Paper No. 2143.

135 R Rajan and L Zingales (2003) 27.

136 R Cooter and HB Schäfer (2010).

137 See Section 3 for specific examples drawn from Latin America.

138 R Rajan and L Zingales (2003).

The first obstacle is linked to the institutional deficiencies that are prevalent in emerging countries.[139] As it was explained above, arm's length finance requires a solid infrastructure on which economic agents can fall back to enforce their explicit agreements (i.e. contracts, legal rules). Accordingly, the degree to which a nation can support the enforcement of explicit agreements will have an impact on the ability of its financial system to sustain arm's length interactions. As it will be explained in Chapters III and VI, the infrastructure of developing countries is not up to the task of allowing for the enforcement of explicit arrangements in the context of corporate activity.

To make things worse, the ability to support the enforcement of explicit agreements cannot be developed overnight, a problem best illustrated by the experience of multinational organizations with institutional reform across the developing world.[140] In the absence of the infrastructure required to back up the enforcement of explicit agreements between economic agents, it will be difficult for developing nations to make the transition towards a more balanced financial system that supports arm's length interactions. It must be noted that, even without arm's length interactions, market-based finance could be grounded on informal exchange.[141] However, the discussions in Chapters IV and VI suggest that the latter's ability to support the provision of financial services may be limited in both scale and scope.[142]

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[139] Id.

[140] For a discussion of these efforts in Latin America, see Chapter VI.

[141] See Chapter IV.

[142] See also RJ Gilson and C Milhaupt, Economically Benevolent Dictators: Lessons for Developing Democracies, (2011) 59 AMER J COMP L 1.

The second obstacle relates to a political economy problem that can delay or stop reform efforts.[143] Financial systems produce rents for different groups of firms and individuals. These parties have incentives to form interest groups through which they can coordinate efforts to block any changes that could reduce their rent-extraction activities, regardless of whether reform would also enhance overall welfare.[144]

The transition to a mixed financial system may pose a direct threat to these interest groups.[145] For instance, local firms that thrive under a relationship-based, bank-oriented system may stand to lose significant rents if the financial system becomes more balanced, since the transition can erode the economic advantages of incumbent firms by expanding access to financial services.[146] As the support for arm's length interactions and market-based finance increases, newcomer firms will be better able to challenge the dominance of these incumbents. The transition could also reduce the ability of incumbents to conduct their business under the traditional recipe of relying on 'contacts and relationships'.[147]

The opposition of incumbents against any measures meant to balance the financial system can be particularly acute in developing countries.[148] Private wealth in these

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143 BR Cheffins, 'Law as Bedrock: The Foundations of an Economy Dominated by Widely-held Public Companies' (2003) 23 OXFORD J LEGAL STUD 11, 17.

144 Some authors refer to this political economy issue as the 'Olson problem'. The Olson problem, which takes its name from the celebrated economist Mancur Olson, can be summed up as follows: 'Reforms that, by stimulating growth, will increase the size of the overall pie are blocked by groups who, economically successful and therefore politically influential under the existing regime, believe that their positions will be threatened by the growth-inducing reforms'. RJ Gilson, H Hansmann and M Pargendler (2010).

145 R Rajan and L Zingales (2003) 32.

146 RJ Gilson (2007).

147 R Rajan and L Zingales (2003) 32.

148 LA Bebchuk and Z Neeman, 'Investor Protection and Interest Group Politics' (2010) 23 REV FINANC STUD 1089, 1119.

jurisdictions is frequently concentrated in clusters of firms controlled by influential families with considerable political influence.[149] Since the insiders in control of these corporate groups stand to lose significant rents if the financial system becomes more balanced, they will use their considerable influence and wealth to oppose any initiatives that are proposed towards this end. In their self-interested efforts to block reform, these insiders may openly obstruct legislative proposals or resort to subtler tactics such as the promotion or acceptance of ineffective rules.[150] Other interest groups that could lose rents under a more balanced financial system, such as incumbent financiers and politicians, may often join in the efforts to resist change.[151]

In sum, the transition from a largely relationship-based, bank-oriented system to one of a more balanced nature must overcome not only the difficulties of any process of reform, but also the muscular opposition of local interests groups. This is evidently not an easy task. Any proposals designed to accomplish the transition mentioned above must take into account a wide array of country-specific factors, including local economic conditions, the prevailing institutional background, the structure of the financial system, the presence of local interest groups and existing social, political and economic arrangements. Past efforts to assist developing countries in the transition to a system with

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149 T Khanna and Y Yafeh, 'Business Groups in Emerging Markets: Paragons or Parasites?' (2007) 45 JEL 331, 372.

150 See Chapter VI for an explanation of this argument in the context of Latin America. See also M Ventoruzzo, 'Takeover Regulation as a Wolf in Sheep's Clothing: Taking Armour & Skeel's Thesis to Continental Europe', Penn State Legal Studies Research Paper 2008 http://ssrn.com/abstract=1084429.

151 R Rajan and L Zingales (2003) 32.

enhanced support for arm's length, market-based finance have not always factored in these different items.[152]

3. The evolution of financial systems in Latin America

The brief review of the finance-growth nexus presented above spells out valuable lessons for Latin America. Financial systems in the region have a marked orientation towards relationship-based finance and are dominated by a strong banking industry.[153] Arm's length interactions and stock markets play a less prominent role in supplying financial services. Although the prevalence of relationships and banks has traditionally been well suited to match the region's economic fundamentals, this may no longer be the case in a few Latin American nations.

Driven by the financial liberalization process of the 1990s, an increasing degree of political stability, the influx of foreign direct investment, changes in industrial patterns and an expanding investor base, some countries in the region have witnessed an escalating demand for financial systems that can provide a better support for arm's length and market-based finance. These pressures will only become more salient as the plans to integrate the region's largest economies are set in motion. Going forward, the ability of Latin American nations to provide financial services in accordance with the region's needs may require more balanced financial systems.

This Section develops the idea that there may be a growing mismatch between the demand and supply of certain financial services across a select group of Latin American countries. The first part of this Section briefly looks at the current state of financial

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152 See Chapter VI.

153 A de la Torre and SL Schmulker (2007).

systems in the region. As mentioned above, the available data suggest that the banking industry dominates finance in Latin America, while relationship-based interactions with banks have lost ground but are still prevalent across the area. The second part of this Section examines some of the conditions that could generate an increased demand for arm's length and market-based interactions in a small sample of Latin American nations.

A. Latin American finance

Latin America is a diverse place. Although most countries in the region share a common language and rather homogenous cultural values, the differences between them can be striking. Brazil, the area's economic juggernaut, is perhaps one of most prominent developing countries in the world, along with India and China.[154] The Brazilian experience is quite different to that of countries like Ecuador and Bolivia, which have some of the highest poverty rates outside of Africa.[155] The political balance in the region is also far from homogenous. While some countries more or less adhere to democratic values (i.e. Colombia, Chile, Mexico, Peru), other nations have started to experiment with semi-dictatorial populism (i.e. Bolivia, Ecuador, Venezuela).[156]

Despite these differences, certain common trends can be identified in the region's financial markets. In general, Latin American countries are characterized by strong banking sectors, weak stock markets and the dominance of large business groups. Taken

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154 As of 2011, Brazil was the seventh largest economy in the world, after achieving a growth rate of 7.5% in 2010. See Measuring Brazil's economy: Statistics and lies, ECONOMIST (10 March 2011). See also R Bonelli, Strenghtening long-term growth in Brazil, (2010) OECD Working Paper, available at http://www.oecd.org/dataoecd/30/40/46454631.pdf

155 MH Palucci and IA Costa, Poverty and human development: Global strategies, (2007) 15 REV LATAM ENF, 713-6

156 M Reid (2006).

together, these factors may reduce the quality of the services provided by the region's financial systems, with adverse effects for economic growth. To shed some light on how this may occur, it is necessary first to take stock of the available data on the region's financial markets.

Latin American firms traditionally relied on internally generated resources to carry on their operations and fund industrial expansion. Encouraged by the region's financial development, however, firms from many countries started to break away from this pattern during the 1990s. As things currently stand, external finance has become the dominant source of firm growth in some of Latin America's largest economies, including Brazil, Colombia, Chile and Uruguay, as illustrated by Figure 1. This switch from internal to external finance is considered to be an important factor in the accelerated pace of growth shown by some Latin American firms during the past 20 years.[157]

External finance may come from many sources, including banks, equity, leasing, supplier credit, development bank funds and informal sources.[158] Each one of these components weighs in differently across Latin American nations. Still, as shown in Figure 2, banks dominate the landscape in almost every country, peaking at close to 40% of all the external finance provided in Chile and Uruguay. Most available indicators in fact suggest that Latin American finance is heavily reliant on the banking industry.[159] The

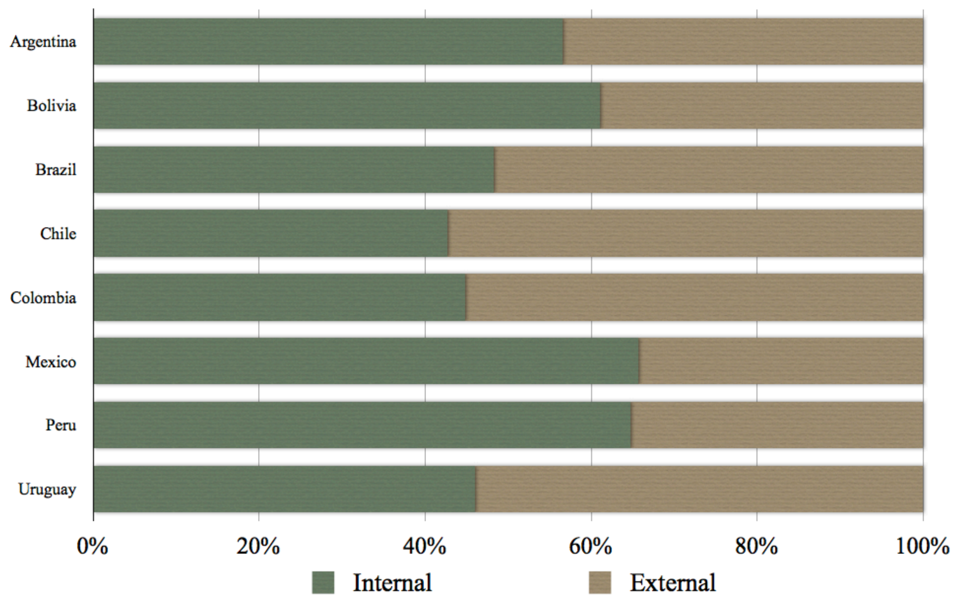
157 MQ Agnoli and D Vilan, Financing trends in Latin America, (2008) 93 ECON REV 3; A Singh and others, Stabilization and Reform in Latin America: A macroeconomic perspective on the experience since the early 1990s, (2005) International Monetary Fund Occasional Paper No. 238.

158 T Beck and others (2008).

159 MQ Agnoli and D Vilan (2008).

financial systems of Latin America are even more tilted towards banking than those of similar countries across the developing regions of Asia and Eastern Europe.[160]

Figure 1
Internal vs. external finance in Latin America



Source: Beck and others, Financing patterns around the world, (2008) 89 J FIN ECON 467-487.

Moreover, as illustrated in Figure 3, the region's banking sector is highly concentrated.[161] Banking concentration in Latin America followed the process of financial liberalization carried out in the region during the 1990's and accelerated as a result of local financial crises and increasing entry by foreign banks.[162] Banking concentration is not necessarily bad for the region, as financial institutions with

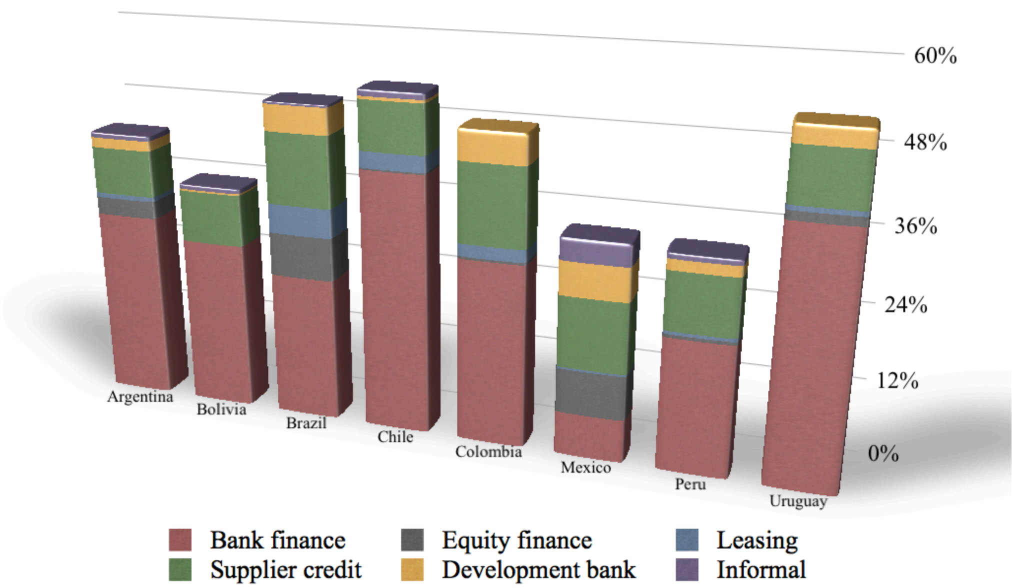
160 Although the mix between banks and stock markets has fluctuated historically in these three regions, it is fair to say that the banking industry represents a heavier component of the financial system in Latin America than in Asia and Eastern Europe. See A García Herrero and others, Latin American financial development in perspective, (2003) Finance Working Paper, available at http://ideas.repec.org/p/wpa/wuwpfi/0304008.html

161 It is also interesting to note that Latin American banks are amongst the most profitable in the world. See http://www.valor.com.br/financas/1003246/latinos-vao-liderar-rentabilidade.

162 MS Martinez Peria and A Mody, How foreign participation and market concentration impact bank spreads: Evidence from Latin America, (2004), World Bank Policy Research Working Paper 3210, 2.

significant market power can invest in long-term relationships with more ease than their smaller counterparts.[163] However, the consolidation of the banking sector may also be tied to an increase in the cost of financial intermediation, which can exclude potential borrowers from the financial system.[164] These contrasting issues will be addressed in further detail below.

Figure 2
Breakdown of external finance components



Source: Beck and others (2008)

The dominance of the banking industry in Latin America stands in stark contrast to the underdevelopment of the region's stock markets. Stock markets in Latin America are small and illiquid, particularly when compared to countries with similar economic and

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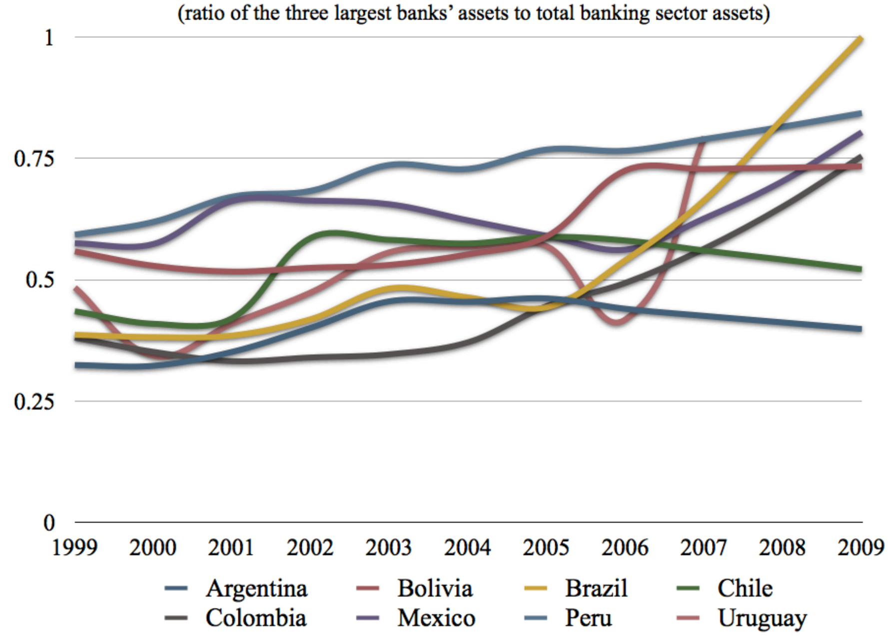
163 N Cetorelli and PE Strahan, Finance as a Barrier to Entry: Bank Competition And Industry Structure in Local U.S. Markets, (2003) Wharton Financial Institutions Center Working Paper No. 22. See also F Allen (2004) 2 and GE Chortareas, JG Garza-Garcia and C Girardone, Banking sector performance in Latin America: Market power versus efficiency, (2011) 15 REV DEV ECON 2, 307-325.

164 'The impact of high spreads is likely to be more severe for developing countries where, given that capital markets are generally small and under-developed, a larger percentage of firms and individuals tend to depend on banks to meet their financial needs'. MS Martinez Peria and A Mody (2004) 3.

institutional backgrounds.[165] Although regional stock markets experienced a spurt of growth during the 1990s, the pace of development slowed down in most countries over the last decade.[166] Figure 4 shows the total number of IPOs in select Latin American countries for the period 2005 to 2011, while Figure 5 shows the total number of listed firms in these same countries as of March 31, 2012.[167]

Figure 3
Concentration of the banking sector in Latin America (1999-2009)
(ratio of the three largest banks' assets to total banking sector assets)



Source: World Bank, World Development Indicators

The data displayed above suggest that Latin American financial systems are much more oriented towards banking than towards capital markets. This is a well-known and uncontroversial fact.[168] However, ascertaining the weight of relationship-based finance relative to arm's length finance across these systems is a more challenging task due to the

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165 A de la Torre and SL Schmulker (2007).

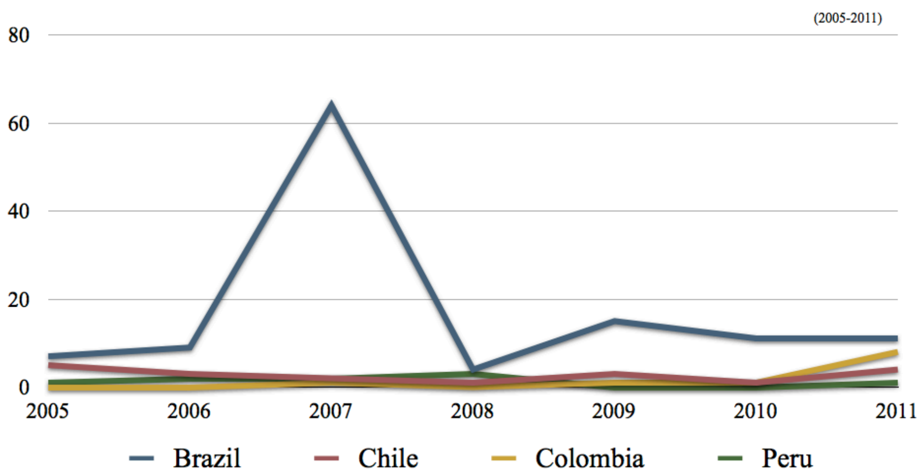
166 MQ Agnoli and D Vilan (2008).

167 For detailed information about the operation of capital markets in Latin America, including liquidity measures and other relevant indicators, see A de la Torre and others (2012).

168 A de la Torre and SL Schmulker (2007); T Beck (2003).

absence of standard indicators concerning the importance that these two mechanisms might have in a particular country. Nevertheless, the defining characteristics of relationship-based and arm's length finance offer some hints as to the mechanism that prevails across most of Latin America.

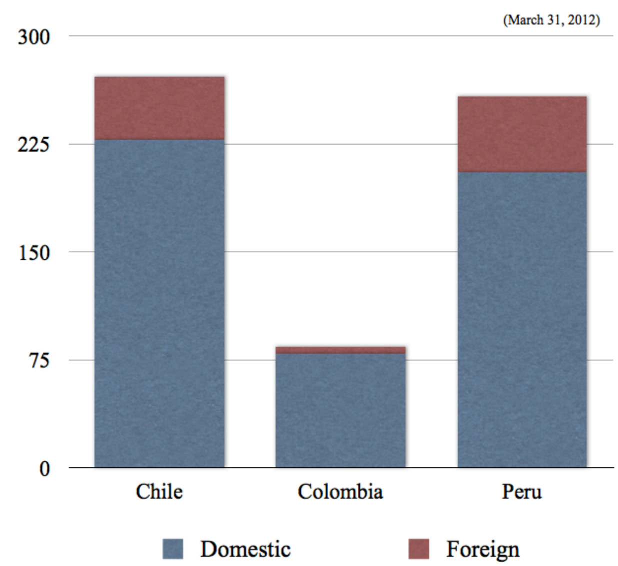
Figure 4
Total Number of IPOs in Brazil, Chile, Colombia and Peru



Source: BOVESPA (Brazil), BVS (Chile), BVC (Colombia), BVL (Peru), BMV (Mexico)

To restate a point made earlier, banks are particularly well placed to thrive in relationship-based systems, as they can invest in long-term relations with their clients and collect information about their profitability that is unavailable to other parties. Moreover, relationship-based systems have a comparative advantage in countries with a weak enforcement infrastructure, where the ultimate outcome of explicit agreements is uncertain at best. In contrast, arm's length systems are more compatible with a robust infrastructure that can provide the necessary support for the enforcement of explicit agreements. The match between each system and different institutional backgrounds is accurately captured by what has been dubbed as the 'inverse tightness rule', according to which ‘loose state law’ corresponds with ‘tight relationships’ between economic agents and ‘tight state law’ is compatible with ‘loose relationships’.[169]

Figure 5
Total Number of Listed firms in, Chile, Colombia and Peru



Source: WFE, BVS, BVC, BVL

With this in mind, one may point to several traits of Latin America’s financial systems that hint at the regional importance of relationship-based interactions. First, as mentioned above, Latin America’s financial systems are heavily reliant on the banking industry, with only a minor role reserved for stock markets as providers of financial services, a distinguishing feature of systems tilted towards relationship-based finance.[170]

Second, the weak enforcement infrastructure of Latin American nations does not provide sufficient support for a full-fledged system of arm’s length finance. Indicators measuring the rule of law and contract enforcement are in fact extremely low in the

169 R Cooter and HB Schäfer (2010).

170 R Rajan and L Zingales (2003).

region.[171] Although this does not rule out the existence of arm's length transactions in certain contexts, incomplete enforcement makes this form of finance relatively less important than relationship-based interactions in Latin America.

Third, in light of Latin America's enforcement deficiencies, some commentators have suggested that the operation of stock markets in the region is mostly based on relationship-based interactions. In the absence of enforceable explicit agreements, insiders in listed firms may be inclined to cultivate a reputation for 'fair dealing', as a means to raise capital, shed firm-specific risk and reduce their liquidity costs under increasingly favourable conditions (i.e. lower cost of capital) through consecutive rounds of secondary share offerings.[172] There is some evidence that this may indeed be the case in certain Latin American countries.[173] The process that allows for relationship-based interactions to support exchange in capital markets is the subject of Chapter IV.

Fourth, the structure of credit relations also suggests that relationship-based finance may still carry more weight than arm's length finance in Latin America. 'Related lending' between financial institutions and their affiliates is a common phenomenon in Latin America, as a considerable number of banks are directly under the control of local business groups.[174] 'Relationship lending', under which banks and their client firms engage in repeat dealings over long periods of time, has traditionally been widespread in Latin America. Lending relations of this nature are a clear example of relationship-based

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171 See rankings at http://worldjusticeproject.org/rule-of-law-index/ and www.doingbusiness.org

172 A Gomes (2000).

173 M Santiago-Castro and CJ Brown, Ownership structure and minority rights: A Latin American view (2007) 59 J ECON BUS 430; A Gomes (2000).

174 Although these business and ownership ties can certainly be beneficial for groups and banks, they may also have negative repercussions on other economic agents including investors and standalone firms. R La Porta, F Lopez-de-Silanes and G Zamarripa, Related lending, (2003) 118 QUART J ECON 1, 231-268.

finance, as they allow financial institutions and firms to share information and enter into long-term implicit contracts.[175]

Relationship lending became less prevalent after the financial liberalization process of the 1990s and moderate improvements in the judicial enforcement of loan agreements, one of the few areas in which arm's length finance is starting to gain ground across Latin America. Nevertheless, lending of this sort is still present to a significant extent in the area.[176] The nature of the relations between financial institutions and their clients, as evidenced by the ubiquity of relationship and related lending, suggests that relationship-based interactions still outmatch arm's length finance in Latin America.

Fifth, the dominance of business groups in Latin America is perhaps a clear example of the 'tight relationships' to which the inverse tightness rule refers, another clue that points to the dominance of relationship-based interactions in the region. As already suggested above, private wealth in Latin America is largely concentrated in family business groups with considerable political and economic clout, known as the *grupos*.[177] The 'internal markets' that exist within these business groups can substitute for local drawbacks such as insufficient sources of funds, deficiencies in the supply of labour and poor contractual enforcement.[178] Although these 'internal market' benefits might be

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175 AW Boot (2000).

176 A de la Torre, MS Martinez and SL Schmulker, Bank involvement with SMEs: Beyond relationship lending, (2008) World Bank Working Paper.

177 T Khanna and Y Yafeh (2007) 331-372. See Chapter VI for an analysis of Latin American *grupos*.

178 J Siegel and P Choudhury, 'A Reexamination of Tunnelling and Business Groups: New Data and New Methods' Harvard Business School Working Paper No. 072/2010 http://www.hbs.edu/research/pdf/10-072.pdf. Established firms within a group can supply operational infrastructure and reputational benefits to new, high-growth ventures. Firms within a group can also share training centres and other facilities that mitigate the problems tied to lack of qualified labour. See M Bertrand and S Mullainathan, 'Pyramids' (2005) 1 JEEA 478, 483.

redundant in industrialized countries, they appear to be useful under the particular conditions that prevail in Latin America, an idea that will be revisited in Chapter VI.[179]

For instance, business groups can deal with hold-up problems arising from the inadequate enforcement of contracts.[180] The shortcomings of a country's enforcement infrastructure may impose significant costs on unaffiliated parties that engage in contractual relations.[181] The relation between a firm and its suppliers will probably be a long-term affair involving incomplete contracts.[182] Absent an adjudicator that can fill in the gaps in these contracts ex post, there is ample space for hold-up problems to arise.[183] Vertical integration is one of several potential solutions to this problem, as it allows insiders to exercise the authority inherent to corporate control over its suppliers, which substitutes for the deficient enforcement of incomplete contracts.[184]

'Internal markets' within a group can also support firms in the early stages of development.[185] In this example, a start-up benefits from the use of the group's operational infrastructure,[186] access to internally generated resources from other group

179 T Khanna and Y Yafeh, 'The Future of Business Groups in Emerging Markets: Long-run Evidence from Chile' (2000) 43 ACAD MANAGE J 268, 285

180 T Khanna and Y Yafeh (2007).

181 R Morck and M Nakamura, Business Groups and The Big Push: Meiji Japan's Mass Privatization And Subsequent Growth, (2007) NBER Working Paper No. 13171.

182 For a description of long-term bilateral contracts of this nature, see OE Williamson, The Mechanisms of Governance (OUP 1996).

183 According to R Morck and M Nakamura (2007), 'group firms can safely deal with other firms in the same group while freestanding firms risk being cheated at every turn' (at 6).

184 OE Williamson (1996) 103. See also S Belenzon, T Berkovitz and P Bolton, 'Intracompany Governance and Innovation' NBER Working Paper No. 15304/2009 http://www.nber.org/papers/w15304.pdf; T Khanna and Y Yafeh (2007); R Morck and M Nakamura (2007).

185 RW Masulis and others (2012).

186 M Bertrand and S Mullainathan (2005) 483.

firms or debt finance from affiliated banks,[187] the use of training centres to mitigate the problems of unqualified labour,[188] credibility before suppliers and consumers derived from the group's reputation,[189] a lower stigma of failure as compared to a standalone firm and access to a supply chain controlled entirely by the group.[190]

In sum, the evidence strongly suggests that financial systems in Latin America are reliant on the banking industry and relationships to a much larger degree than on stock markets and arm's length finance. Of course, the extent to which this is an accurate portrayal of Latin American financial systems is highly country-specific, as several nations in the area have made great strides towards a more balanced financial system. Countries such as Brazil, Chile, Colombia, Mexico and Peru not only experienced some stock market growth over the past two decades, but have also invested to improve their enforcement infrastructure.[191] Nevertheless, there are signs that these developments have been insufficient to match Latin America's increasing demand for a more balanced mix of financial services. To this we turn next.

B. The fractures in Latin American finance

Latin America embarked on an ambitious liberalization process during the 1990s.[192] The region's economies, historically prone to protectionism, opened their

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187 J Siegel and P Choudhury (2010); T Khanna and Y Yafeh (2000).

188 S Belenzon, T Berkovitz and P Bolton, (2009).

189 T Khanna and K Palepu, Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups, (2000) 56 J FIN 2.

190 H Almeida and D Wolfson (2006).

191 CE Tovar and MQ Agnoli, New financing trends in Latin America: An overview of selected issues and policy challenges, (2008) 93 ECON REV 3.

192 MQ Agnoli and D Vilan (2008).

borders to international firms and foreign financial intermediaries, with mixed results. After a brief period of fast growth, Latin America was immersed in a series of economic crises that gave way to a tectonic shift in the region's political preferences. Argentina's turn-of-the-century crisis, for instance, which saw the country's economy shrink by 28% between 1998 and 2001, was followed by a decade of robust opposition against the neo-liberal, free-market ideology that local politicians blamed for the country's travails.[193] Economic turmoil and social inequality fuelled the rise of radical populism in countries such as Venezuela, Ecuador and Bolivia, in which the proceeds from the exploitation of natural resources are now being used to dismantle 'western-type' institutions.[194]

Not every country followed this path. In Brazil, stable economic growth ushered in moderate governments with policies that sought to combine market institutions and social democratic principles, to make 'capitalism work for the poor'.[195] A similar approach was adopted in Chile, Colombia, Mexico and Peru, where gradual reforms and sound macroeconomic policies have led to sustained growth.[196] These four nations recently unveiled plans to form the Latin American Pacific Alliance, a new trading bloc that will deepen their economic integration in pursuit of the free movement of goods,

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193 R Muir, Social democracy reborn? The Latin American left in government, (2011) 19 RENEWAL 1; J Saxton, Argentina's economic crisis: Causes and cures, (2003) Joint Economic Committee of the United States Congress.

194 M Reid (2006).

195 R Muir (2011).

196 CE Tovar and MQ Agnoli (2008). Over the past few years, Peru followed a path of gradual reforms and sound policies that led to GDP growth rates of 9.8% in 2009 and 8.8% in 2010. However, the election of Mr. Ollanta Humala of the Peru Wins party in 2011 increased the uncertainty concerning the country's economic prospects. After news of Mr. Humala's victory became known, the Lima Stock Market main index fell by 12%, 'prompting temporary suspension of trading and fears of capital flight'. R Carroll, Left-winger Ollanta Humala's win in Peru unnerves markets, GUARDIAN (6 June 2011).

services, capital and people'.[197] Moreover, the recently created Latin American Integrated Market (MILA, after its acronym in Spanish), which groups the stock exchanges of Colombia, Chile and Peru, is already the second largest market in Latin America.[198] If the reported plans of the Mexican and Panamanian stock exchanges to join MILA come to fruition, the integrated market would pose a serious challenge to the status of Brazil's BOVESPA as the most important exchange in the region.[199]

The growing schism between the political and economic preferences of Latin American nations pits pro-market social democracies against radical populists with an anti-capitalist streak, in what has been dubbed 'the battle for Latin America's soul'.[200] Although the first group has succeeded in reducing poverty and inequality through a mix of economic growth and social policies, the prospect of a shift towards radicalism still looms in the horizon.[201] The continued adherence to moderate economic and social policies may hinge on the ability of some of these countries to support further growth.[202] In turn, sustained economic growth going forward will depend on a large number of factors, amongst which financial development can play a useful role.

As it was explained earlier, the adequate provision of financial services can facilitate the process of economic growth. Nevertheless, it appears that the financial

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197 Peru, Chile, Colombia and Mexico discuss measures to implement Pacific Alliance, ANDINA (19 June 2011).

198 MILA has over 560 listed companies with a total market capitalization close to $660 billion. See A Oppenheimer, South American stock exchange: The way to go, MIAMI HERALD (16 February 2011) and The Benefits of MILA: Three Latin American stock exchanges unite, KNOWLEDGE WHARTON (17 November 2010). See also Chapter VII.

199 B Schmidt, E Thomson and A Emery, Andean Nations overtaking Mexican Stock Exchange lure ING, Global X Funds, BLOOMBERG (30 May 2011).

200 M Reid, Forgotten continent: The battle for Latin America's soul, (2007) Yale University Press.

201 Id.

202 Id.

systems of Latin American nations have not kept up with the region's changing needs. Recent empirical studies suggest that 'capital markets in Latin America exhibit a systematically lower-than-expected level of development'.[203] This fact may be particularly worrisome for those countries that have followed moderate economic policies, as it erodes confidence in their efforts to nurture market institutions. Reforms designed to improve the enforceability of explicit agreements do not seem to have fared any better, as evidenced by available indicators.[204]

These shortcomings are all the more evident in the face of the growing demand for arm's length and market-based finance across the fastest developing countries in Latin America. To this effect, a survey conducted amongst Latin American entrepreneurs singled out the lack of adequate financial services as the largest obstacle to economic development in the region.[205] This growing mismatch between the supply and demand of financial services in Latin America may be due to many potential causes, two of which are analysed below.

(i) Changing economic fundamentals

As explained in the previous Section, the ability of a financial system to supply growth-enhancing services depends on the correspondence between its internal components (i.e. its 'architecture') and the economic fundamentals of a specific jurisdiction. To this effect, there seems to be a growing mismatch between the supply and the demand of financial services in certain Latin American countries. As mentioned

[203] A de la Torre and SL Schmulker (2007) 130.

[204] CE Tovar and MQ Agnoli (2008).

[205] AM Herrera and E Lora, Why so small? Explaining the size of firms in Latin America, (2005) 28 THE WORLD ECONOMY 7.

above, financial systems in the region, tilted towards relationship-based finance and dominated by banks, are mostly well matched to the weak institutional background and small, homogenous economies of Latin America. However, the rapid development of certain countries in the area is putting a strain on the ability of financial systems to meet the changing demand for growth-enhancing services. These pressures are most conspicuous in pro-market social democracies such as Brazil, Chile, Colombia, Mexico and Peru, where foreign and domestic parties are starting to require increased support for arm's length, market-based finance.[206] The following paragraphs give a bird's-eye view of the factors that are driving this increasing demand for more balanced financial systems in the area.

—Larger, more diverse economies

The rate of economic development in Latin America has fluctuated drastically over the past few decades. After the growth spurts of the 1960s and 1970s, the region went through a 'lost decade' of sluggish development during the 1980s and a moderate recovery during the 1990s.[207] Over the last decade, a select few countries have undergone steady growth despite financial turmoil in global and regional markets. Brazil, the largest economy in the region, posted an annual GDP growth average of 4.40% over the past 5 years, less than Peru (7.06%), but higher than Colombia (4.32%), Chile (4.04%) and

206 Aside from the developments described here in detail, there are several additional factors that may have increased the demand for arm's length, market-based finance in the region, including the expansion of the retail and institutional investor base tied to an ongoing privatization process across these nations and the large financing needs triggered by the multiple infrastructure projects currently underway in the region.

207 N Loayza, P Fajnzylber and C Calderon, Economic growth in Latin America and the Caribbean: Stylized facts, explanations, and forecasts, (2004) Central Bank of Chile Working Paper No. 265.

Mexico (1.74%).[208] Each of these countries also recovered swiftly from the global financial crisis of 2008, with GDP growth during 2010 amounting to 8.78% in Peru, 8.5% in Chile, 7.5% in Brazil, 5.5% in Mexico and 4.5% in Colombia.[209] These rates of growth have been attributed to increasingly strong ties with Asia and sound macroeconomic policies, two factors that are likely to remain constant in the coming decade.[210]

The steady enlargement of these Latin American countries, along with an increase in industrial diversity, may be pushing the limits of the traditional relationship-based, bank-oriented system of finance.[211] As explained in Section 2 above, a system of this nature is mostly compatible with small economies with poor industrial diversity, where a limited number of players can interact repeatedly with each other. This is one reason for which arm's length interactions might be necessary to support further growth in the region.

Moreover, as economies expand and their industries become more diverse, price signals about the profitability of firms gain importance due to the expansion of investment opportunities and the increased number of firms and financiers. If price signals are unavailable or obscured due to the lack of support for market-based finance, it may be exceedingly difficult for financiers to meet the demand for financial services. Also, as explained earlier, the lack of price signals may have a negative effect with regard to the reallocation of resources as economies become larger and more diverse.[212]

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208 See World Development Indicators (2012), available at http://data.worldbank.org/indicator

209 Growth was only slightly weaker during 2011. See World Development Indicators (2012).

210 S Romero, Latin America's economies surge forward, NEW YORK TIMES (30 June 2010).

211 For a summary of industrial diversity in Latin America, see Industrial development report: Breaking in and moving up, (2009) United Nations Industrial Development Organisation.

212 R Rajan and L Zingales (2003).

—Larger firm size

The surging demand for market-based and arm's length finance in Latin America is also due to increases in the size of local firms over the past decade. The market capitalization of listed firms in Brazil, measured as a percentage of GDP, swelled up from 33.6% in 2001 to 73.2% in 2009, peaking in 2007 at 100.3%.[213] The total market capitalization of Chilean listed firms grew from 82.1% in 2001 to 128% of GDP in 2009 and in Peru from 20.6% to 55% in these same years. In Colombia and Mexico, listed firms grew from 2001 values of 13.4% and 20.3% to 57% and 38.9% in 2009, respectively. In addition, after tapping their local markets, the largest firms in each of these countries have raised funds abroad, primarily in the United States. As of June 2012, 27 Brazilian companies were listed on the New York Stock Exchange, with fewer Mexican (18), Chilean (11), and Peruvian (3) and Colombian (2) firms pursuing this route.[214]

Firms are also constantly entering domestic stock markets in these four countries. The number of IPOs in BOVESPA, Brazil's stock exchange, peaked at 63 in 2007, with only 4 IPOs in 2008, 6 IPOs in 2009 and 11 IPOs in 2010.[215] Although Chilean IPOs have been relatively scarce over the same period, averaging two yearly IPOs from 2007 to 2010, 5 new companies went public in 2011.[216] The number of IPOs in the Colombian and Peruvian Stock Exchanges also picked up pace after a couple of years in which no

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213 World Development Indicators (2012)

214 NYSE Listings Directory, available at www.nyse.com

215 Global IPO trends 2011, ERNST & YOUNG, available at www.ey.com.

216 Economy boosts number of IPOs in Chile, MARKETWATCH (20 June 2011).

new companies listed their shares for trading, with Colombia setting a national record for new IPOs in 2011.[217] Finally, the Mexican Stock Exchange performed better than its Chilean, Colombian and Peruvian counterparts, with 6 IPOs in 2010.[218]

—Increasing importance of human capital

The economies of Latin America have historically swayed towards industries that are intensive on physical assets. The region's financial systems, mostly relationship-based and dominated by banks, provide a suitable match for this setting.[219] Nevertheless, the past few years have witnessed an expansion of industries that are more reliant on human capital. On the demand side, the services industry has gained importance in the countries analysed here. In Brazil, for instance, services made up 67.5% of the GDP for 2010, while industry and agriculture accounted for 26.4% and 6.1%, respectively.[220] Mexico also has a strong services sector, which contributed 62.5% of GDP in 2010, as opposed to the industrial sector's 33% and agriculture's 4.2%. The services industry made up a lower percentage of GDP in Peru (54%), Chile (53.9%) and Colombia (52.7%) during that same year.[221]

On the supply side, the countries mentioned above have moved to correct the market failure in human capital formation known as the 'skill gap', which still afflicts the

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217 AviancaTaca launches IPO in Colombian bourse, WALL STREET JOURNAL (29 March 2011).

218 Mexican stock exchange expects 10 IPOs in 2011, REUTERS (11 November 2010).

219 F Allen, L Bartiloro and O Kowalewski (2007).

220 The World Factbook, Central Intelligence Agency, available at www.cia.gov/library/publications/the-world-factbook/

221 Id.

region.[222] Mexico, Chile and Colombia have launched successful programs to train high-skilled workers in the United States and the European Union.[223] Moreover, all of the countries surveyed here have a strong middle class with an increasing number of average years of education.[224] In fact, the enrolment deficit in secondary and tertiary education has decreased importantly in these countries over the past 40 years.[225] These policies are already starting to produce results, such as the increase in rates of publication for scientific studies, which more than tripled between 1988 and 2001.[226] Nevertheless, the rate of innovation remains stunted across Latin America, as new innovation processes are not only of an incremental nature but also mostly developed by foreign firms.[227]

An increasingly educated middle class, added to the growth of the services sector, will accentuate the need for a financial system that can support firms with significant investments in human capital. As it was explained in the previous Section, a financial system heavily weighted towards relations and banks may not be ideal in this setting.[228]

—Foreign investment

222 WA Schwalje, The prevalence and impact of skills gaps on Latin America and the Caribbean, (2011) 5 UNIVERSIA 1.

223 See, for instance, www.colfuturo.com.co (Colombia) and www.becaschile.cl (Chile).

224 Country Notes, Latin American Economic Outlook, available at http://www.latameconomy.org/en/

225 O Arias, AM Diaz and M Fazio, Breaking the cycle of underinvestment in human capital in Latin America, (2005) World Bank Working Paper.

226 R Grosse, R&D by TNCs in Latin America, (2005) UNCTAD Working Paper.

227 See World intellectual property indicators 2009, World Intellectual Property Organisation. However, change might be at hand, as illustrated by the increase in venture capitalists that have started to set their sights in the region. See R Dasso, Entrepreneurship draws VCs to Latin America, MARKETWATCH (3 June 2011).

228 R Rajan and L Zingales (2001)

Following the liberalization process of the 1990s, there was a dramatic increase in the flow of foreign investment into Latin America. The foreign capital flows that had been channelled into public investments in previous decades were now being poured into the private sector through portfolio investments and foreign direct investments (FDI).[229] Portfolio investments were initially strong, representing close to 39% of all capital flows to the region, but then collapsed due to increasing political uncertainty after the Latin American financial crises of the turn of the century.[230] By 2005, portfolio investments represented only 7.6% of all the capital flows reaching the area.[231]

FDI, on the other hand, has become the most important source of investment in Latin America.[232] FDI flows to the region almost tripled between 1994 and 2008.[233] Unsurprisingly, some of the main recipients of FDI have been the countries with the best track record of political and economic stability in recent years: Brazil, Chile, Colombia, Mexico and Peru.[234] The services and manufacturing sectors in these nations have been particularly favoured by this rise in FDI flows.[235]

As part of incoming FDI, the past few years have seen an increasing amount of acquisitions of Latin American firms by foreign companies.[236] In 2010, 203 inbound cross-border transactions were executed for a total value of $72.3 billion, mostly by

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229 MQ Agnoli and D Vilan (2008).

230 CE Tovar and MQ Agnoli (2008)

231 MQ Agnoli and D Vilan (2008).

232 A Calderon and others, Foreign direct investment in Latin America and the Caribbean, (2008) ECLAC-UNITED NATIONS.

233 Id.

234 Despite its problems, Argentina has also been a major recipient of FDI. See A Calderon and others (2008).

235 Id.

236 Latin American M&A Round-up, MERGERMARKET (20 January 2011).

European and American firms.[237] Most of these deals took place in Brazil, Chile and Mexico and focused on the telecommunications, energy and financial sectors.[238] Finally, private equity funds appear to be investing strongly in Latin America. During 2010, these funds channelled $6.6 billion to the region, an increase of 405% from 2009.[239] The Latin American Venture Capital Association ranks Chile, Brazil, Mexico and Colombia (in that order) as the top destinations for private equity funds in the area.[240]

The increasing presence of foreign investors in Latin America may also be straining the limits of regional financial systems. In fact, these parties lack the '[local] power that is the currency in relationship systems', which constrains their ability to operate in the area.[241] All things being equal, foreign investors will usually favour countries that provide adequate support for arm's length transactions over those in which finance is mostly relationship-based. Accordingly, FDI flows may stagnate in nations that fail to meet this demand for more balanced financial systems, as investors turn to jurisdictions with better support for impersonal exchange.

The relevance of this issue lies with the role that FDI flows may have with respect to economic growth in Latin America. The long list of benefits tied to FDI includes technology spillovers, increased trade integration and the potential expansion of human

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237 Id.

238 Id.

239 J Mitchell, Latin markets benefit from influx of private equity, INSTITUTIONAL INVESTOR (15 March 2011).

240 Rankings available at www.lavca.org

241 The lack of explicit contractual safeguards forced foreign investors in Eastern Asia during the 1990s to have multiple exit strategies, which were triggered after 'an unexpected bad shock'. R Rajan and L Zingales, Which capitalism? Lessons from the East Asian crisis, (1998) 11 J APP C FINAN 3.

capital.[242] FDI also provides an important source of capital to meet the financing demand of local firms, as it is considered to be more stable than portfolio investment flows and bank lending.[243] The desire to capture these economic benefits may push Latin American nations towards more balanced financial systems.

(ii) The shortcomings of the banking industry

It has already been established that the banking sector dominates finance in Latin America. Despite changing economic conditions, the region's characteristically weak institutional environment, small economies and fixed-asset-intensive industries still provide a moderately good fit for bank finance. There are, however, several problems with the services supplied by the banking industry in Latin America. In fact, lending rates are surprisingly low given the level of economic activity in the area, while interest rates are among the highest in the world.[244] Also, the credit provided by banks is only a small fraction of total bank assets, while the depth of financial intermediation channelled through the industry is low given the region's fundamentals.[245]

These adverse conditions are usually attributed to a number of factors, including poor levels of competition between banks, macroeconomic uncertainty, inflation and the

242 OECD, Foreign direct investment for development: Maximizing benefits, minimizing costs, (2002) available at http://www.oecd.org/dataoecd/47/51/1959815.pdf

243 R Grosse, The financing of FDI in Latin America, (2008) 2 UNIVERSIA 3, p 111. Portfolio investments and bank lending 'dried up during the Latin American debt crisis of the 1980s, the Tequila Crisis in 1994-5, the Asian Crisis of 1997-8, the Argentine crisis in 2001-3, as well as in the current global crisis resulting from the US sub-prime mortgage defaults'.

244 JL Oreiro and LF de Paula, Macroeconomic determinants of bank spread in Latin America: A recent analysis with special focus on Brazil, (2010) 24 INT REV APPL ECON 5, 573-590.

245 MQ Agnoli and D Vilan (2008); A Singh and others (2005).

relative unavailability of other sources of finance.[246] At any rate, given the overreliance of Latin American firms on banks, the scarcity of this source of finance and the onerous terms under which it is extended can arguably represent a serious obstacle to economic growth in the region. Of course, general statements about the shortcomings of Latin America's banking sector are of little use unless one identifies the precise ways in which this impacts on firms in the area.

As it was already mentioned, the acute consolidation of the banking sector and the presence of powerful family business groups with close ties to banks can erode the quality of the services provided by the industry that controls the main source of external finance in Latin America. Equally worrisome is the possibility that certain firms are altogether excluded from the financial system or offered services under terms too onerous to compete successfully in local product markets. To unpack these ideas further, it is useful to focus on some specific problems generated by the conditions described above.

First, the high degree of concentration in Latin America's banking sector can represent an obstacle for the emergence of new firms.[247] Studies indicate that banks tend to be more risk-averse as the level of industry concentration increases.[248] This not only produces a reduction in the overall level of access to external finance, but also undermines the reallocation of resources to the most promising high-risk, long-term projects.

A more serious consequence of bank concentration arises when conflicts of interest are thrown into the mix. Financial institutions usually have incentives to preserve

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246 JL Oreiro and LF de Paula (2010).

247 N Cetorelli and PE Strahan (2003).

248 See, for instance, F Allen, SC Myers and RA Brealey (2006) 947.

the profitability of their incumbent clients, which may be eroded if new competitors arise to challenge them. In addition, banks may be more inclined to protect affiliated 'zombie' firms rather than facilitating the entry of newcomers to the industries in which their affiliates operate.[249] Discriminatory lending practices of this sort drive resources away from promising undertakings, 'to the detriment of the entrepreneurial sector of the economy'.[250] As the high degree of concentration in the banking industry reduces the number of potential financiers for firms, newcomers will have a hard time finding the resources to compete against inefficient incumbents. This problem is compounded by the fact that the banking sector is the main source of external finance in Latin America.

These problems are aggravated when a nation's major banks have close ties to local business groups, as is the case across Latin America. In fact, the dominance of family business groups in Latin America can substantially impair the ability of the financial system to provide external finance and to allocate resources efficiently.[251] To be sure, for the reasons described above and in Chapter VI, groups are an important source of economic growth in developing countries. However, the stranglehold that business groups have on finance may also give rise to significant drawbacks.

In a context of bank concentration and close ties between financial institutions and groups, 'connected' firms will have greater access to bank finance—and under more favourable terms—than standalone companies.[252] Groups can use this enhanced access to

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249 Id.

250 N Cetorelli and PE Strahan (2003), 25.

251 R La Porta, F Lopez-de-Silanes and G Zamarripa (2003).

252 'Lending to group companies provides an important rationale behind ownership and control of banks by business groups, particularly when financing from financial intermediaries is not easy because of the group risk or project risk that it entails'. AT Deb and others, Business group ownership of banks: Issues and implications, (2010) IEG Working Paper No. 308, available at

credit facilities to engage in practices that actively 'foreclose markets to independent competitors' (i.e. predatory pricing) or that facilitate looting.[253] Family business groups can also use their political clout or rely on their ties with local banks to directly restrict access to finance for cash-strapped innovators.[254] The upshot is that family business groups focused on preserving existing technologies and protecting their rents displace independent firms that would otherwise be likely to participate in the development of new products and technological processes.[255]

Second, the monitoring and disciplining function usually attributed to banks may be partially compromised in Latin America. Financial institutions with links to local business groups are not in an ideal position to prevent the undue extraction of resources from affiliated firms. Far from it, studies conducted in developing countries show instead that banks affiliated with groups are at a high risk of being looted by controlling shareholders.[256] Even though this problem still persists in many Latin American countries, the increased internationalization of the banking sector and tighter regulation has reduced the ability of insiders to misuse their control over financial institutions.

Moreover, changes in the structure of credit relationships in Latin America may have reduced the incentives of independent banks to discipline their clients. The starting point for this analysis is the idea that banks are naturally more inclined to protect their

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http://www.iegindia.org/workpap/wp308.pdf; see also R Levine (2005), 885

253 I Mahmood and W Mitchell, Two faces: Effects of business groups on innovation in emerging economies, (2004) 50 MANAGEMENT SCIENCE 10, 1351. For an explanation of looting in group-affiliated banks during the 1980's in Chile, see G Akerlof and others, Looting: The Economic Underworld of Bankruptcy for Profit, (1993) 2 BROOKINGS P ECON ACT 22.

254 R Morck, D Wolfenzon and B Yeung 'Corporate Governance, Economic Entrenchment and Growth' (2005) 43 J ECON LIT 655, 720.

255 I Mahmood and W Mitchell (2004).

256 R La Porta, F Lopez-de-Silanes and G Zamarripa (2003).

interests as lenders, rather than to look out for actions that may be detrimental to the other stakeholders of their borrowers.[257] However, the interests of banks and of these stakeholders may be aligned in certain cases. For instance, if the behaviour of insiders threatens a borrower's ability to comply with its obligations on a timely basis or erodes the value of the collateral pledged to secure payment of its debts, a bank may deter insiders from extracting value from the firm through related-party transactions. This might benefit the other stakeholders of the borrowing firm.

Banks that engage in 'relationship lending' have strong incentives to keep close tabs on their client firms.[258] Lending of this nature encourages banks to carry out a screening of potential customers and monitoring of incumbent clients, which might redound to the benefit of a firm's stakeholders.[259] Although relationship lending was prevalent in Latin America, a gradual shift in the structure of credit relations may have undermined the monitoring role of banks.

Following the entry of foreign banks to Latin America during the financial liberalization process of the 1990's, the system of 'relationship lending' that usually dominated finance in the region started to slowly give way to arm's length banking based on short-term loans and collateral.[260] Gradual improvements in the judicial enforcement of credit agreements and in executive collection proceedings also contributed to a

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257 CW Anderson and others, Bank monitoring, firm performance and top management turnover in Japan, in Corporate governance and finance (M Hirschey and others eds., Elsevier Science, 2003).

258 A Garcia and others, Concentration, hold-up and information revelation in bank lending: Evidence from Chilean firms, (2003) Central Bank of Chile Working Paper No. 226, available at http://www.bcentral.cl/eng/studies/working-papers/pdf/dtbc226.pdf

259 OE Ergungor, Foreclosures: Relationship lending in the consumer market and its aftermath, (2006) Federal Reserve Bank of Cleveland Working Paper No. 17.

260 T Nenova and C Hickey, Self-dealing: Sneaking corporate value through the back door, (2006) World Bank Note No. 312. See also N de la Peña and H Fleisig, SMEs and collateral, (2002) CEAL Issued Brief No. 3 for a historical account of the problems that Latin American firms have faced concerning the use of collateral to obtain bank loans.

moderate improvement of arm's length finance in this specific area.[261] Although this partial shift in the structure of lending relationships somewhat improved the general availability of credit for firms, it may have also reduced the incentives for financial institutions to exert a continuous screening and monitoring role over borrowing firms.[262]

The arguments laid out above are not intended to be an indictment of Latin American finance. The services provided by the region's mostly relationship-based, bank-oriented systems are generally compatible with local economic fundamentals and remain central to growth.[263] The point is simply that there are limitations on the ability of these systems, as they currently stand, to meet the needs of all the economic agents that operate in Latin America, particularly in the case of foreign investors and standalone firms with no connection to dominant business groups. These shortcomings need to be addressed.

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261 The slow transition towards arm's length banking still faces many obstacles, including the inadequacy of the governmental apparatus to support the provision of collateral, a problem that disproportionately affects small and medium enterprises. A de la Torre, MS Martinez and SL Schmulker (2008). Several countries in the region have adopted statutes that seek to facilitate the use of collateral in transaction with banks and other counterparties. For a discussion of the results of this experiment, see B Kozolchyk, Implementation of the OAS model law in Latin America: Current status, (2011) 28 ARIZ J INT COMP L 1.

262 The move away from relationship lending may have also mitigated the hold-up problem associated with *ex post* information monopolies. Lending of this nature usually allows a bank to extract rents from firms, which can potentially distort their investment decisions. As a consequence of repeat dealings with their customers, financial institutions can create an information monopoly with respect to the firms to which they have extended credit. This monopoly makes it difficult for borrowing firms to seek financing from competing banks, as this might be taken as a signal that the initial lender is reluctant to provide additional lines of credit. Banks with an information monopoly can hold-up firms, which may increase the cost of bank intermediation and reduce overall access to external finance, one of the core financial services described in Section 2, above. A Garcia and others (2003). See also See J Tirole (2006), 93.

263 JH Boyd and B Smith, The evolution of debt and equity markets in economic development, (1995) Federal Reserve Bank of Minneapolis Working Paper No. 542.

4. Going forward: The importance of domestic stock markets

Improving the availability and the quality of the services provided by the financial sector can facilitate the process of economic growth in Latin America. There are, of course, different ways of pursuing this goal. For instance, the shortcomings of the banking industry could be addressed by removing barriers to competition or enhancing controls on existing ties between financial institutions and corporate groups.[264] For this purpose, Latin American policymakers could perhaps take their cue from countries that have dealt with similar problems in the past, such as Germany, Japan and South Korea.[265]

However, the discussions above suggest that gradual banking reform might be insufficient to ensure that Latin American financial systems will continue to provide a suitable match for the region's changing economic fundamentals. The financial systems of certain Latin American countries have come under significant strain due in part to the pressure exerted by local growth and the region's accelerating integration into the global economy. These factors are stirring up demand for more balanced financial systems with better support for arm's length and market-based finance.

Meeting this demand will present policymakers with the opportunity to assist in the process of economic growth across the area.[266] For instance, propping up arm's length interactions has the potential to increase FDI flows and lead to an improvement of the

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[264] I Love and MS Martinez Peria, How bank competition affects firms' access to finance, (2012) World Bank Policy Research Working Paper 6163. and Facilitating entry for foreign banks can also help, as this enlarges the pool of suppliers of financial services. See MS Martinez Peria and A Mody (2004).

[265] F Allen and others (2010).

[266] RG Rajan and L Zingales (2004).

terms under which foreign firms and financiers invest in Latin America.[267] Improvements in the operation of arm's length interactions in stock markets could open up additional sources of external finance to fuel the growth of newcomer firms and improve the ability of local economies to support human-capital-intensive industries.[268]

Meeting the demand for more market-based finance may have positive spillover effects on Latin America's banking industry. More balanced financial systems might reduce the negative effects tied to the high levels of bank concentration and the links between financial institutions and business groups.[269] In fact, the development of stock markets could reinforce the overall operation of Latin American financial systems, as banks and stock markets can have complementary roles in the process of economic growth.[270]

There are, to be sure, significant obstacles that must be tackled in order for Latin American financial systems to become more balanced.[271] The following Chapters identify these obstacles and lay down a theoretical framework for designing solutions that match the area's particular background and its economic fundamentals. Going forward, this study will mainly focus on the ways in which relationship-based and arm's length interactions can provide support for stock markets. While there may be other ways of improving the diversity of Latin American financial systems, the explanations laid out

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267 B Black, The legal and institutional preconditions for strong securities markets (2001) 48 UCLA L Rev 781, 832.

268 C Mayer (2008). There are other well-known advantages associated with the operation of securities markets, including cross-sectional risk sharing and the reduction of liquidity costs for equity investors.

269 A de la Torre and SL Schmulker (2007); F Allen (2004); Z Bodie and RC Merton (2004).

270 For a review on the notion that banks and stock markets serve complementary roles in economic growth, see R Levine and S Zervos (1998).

271 See Chapter VI.

above suggest that there is still much room for capital markets to assist in the process of economic growth across the region.

Chapter II

Adverse selection and the institutions of capital markets

1. Adverse selection in developing capital markets

On January 4, 2005, the Securities and Exchange Commission filed charges against the controlling shareholder and several top officers of TV Azteca S.A. de C.V., a Mexican company that had cross-listed into the U.S. through an ADR program only a few years earlier.[272] The firm had attracted the attention of American regulatory authorities since 2003, when its legal counsel blew the whistle on multiple violations of the Securities Exchange Act of 1934.[273] The complaint brought by the SEC argued that TV Azteca's controlling shareholder, Ricardo Salinas, had profited illegally from transactions carried out between the firm and another corporation that he secretly controlled.[274] Mr. Salinas allegedly reaped a total payoff of more than $100 million at the expense of the holders of TV Azteca's depositary receipts and in an attempt to cover up his misdemeanour directed the firm to disclose false information to the market.[275] At the time the SEC complaint was made public, a class action lawsuit filed by the company's ADR holders was already making its way through the United States District Court for the Southern District of New

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272 Mr. Salinas, one of Mexico's wealthiest entrepreneurs, firmly believes that all listed firms must have a controlling shareholder. When prompted by a CNBC reporter on the issue, he bluntly responded with the following joke: 'What's a stray dog, an abandoned car, and a public company have in common? They all need an owner'. M Caruso-Cabrera, CNBC Interview with R Salinas (4 February 2009) http://www.cnbc.com.

273 TV Azteca's New York-based legal advisers were amongst the first to make use of Section 307 of the then-newly enacted Sarbanes-Oxley Act. P McGeehan, 'Lawyers Take Suspicions on TV Azteca to its Board' *New York Times* (24 December 2003).

274 See also P McGeehan and J Anderson, 'Chairman of TV Azteca is Charged with Fraud' New York Times (5 January 2005).

275 Securities and Exchange Commission (SEC), Litigation Release No. 19022 (4 January 2005).

York.[276] Although both cases were ultimately settled, TV Azteca and two other cross-listed firms controlled by Mr. Salinas were forced out of the US market.[277]

Aside from the textbook example of investor expropriation, two additional facts about the TV Azteca case are worth exploring. First, Mr. Salinas held absolute control of the firm through a majority voting stake.[278] Controlling shareholder structures are a common feature of corporate ownership in developing countries.[279] Second, Mexican authorities were initially sluggish to investigate TV Azteca's misdeeds.[280] The CNBV, Mexico's main regulatory body, sprang to action only after its hand was forced by news of the SEC's inquiry and the class action lawsuit filed by the disgruntled investors of TV Azteca.[281] Nor do records show any evidence of private litigation against the firm in its home jurisdiction.[282] Lack of credible enforcement, whether by public authorities or private parties, is also a trademark of countries in early stages of development.

The TV Azteca case illustrates, in a nutshell, one of the main pitfalls faced by equity investors in developing countries. Whereas in the US the legal system plays an important role in disciplining controlling shareholders, the defective state infrastructure of emerging nations makes it difficult for market participants to rely on the formal legal

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276 In Re TV Azteca S.A. de C.V. Securities Litigation, Civil Action No. 1:04-CV-546 (JES).

277 SEC, Litigation Release No. 19833 (14 September 2006).

278 TV Azteca SEC Filings, Form 20-F (31 December 2003).

279 R Morck, 'The Riddle of the Great Pyramids', NBER Working Paper Series No. 14858/2009 http://www.nber.org/papers/w14858.pdf; T Nenova, 'A Corporate Governance Agenda for Developing Countries' (2005) Contaduría y Administración 181.

280 'Mexico still has a reputation as the kind of place anyone from a motorist to a corporate chieftain can easily circumvent the rules with a wink and a nod'. G Smith, 'A Lesson in Transparency for Mexico' *Businessweek* (17 January 2005).

281 Id. See also R Hummings, 'Dodgy dealings of Salinas Pliego: TV Azteca boss faces slew of investigations in wake of Unefon financing scandal' *Business Mexico* (1 March 2004).

282 P López, 'Efectos Financieros del Gobierno Corporativo y la Ética en los Negocios en Mexico: Un Análisis Econométrico' XVII Coloquio Mexicano de Econometría (2007) ITSEM-CEM (in file with author).

system as a check on the behaviour of insiders with voting control.[283] One can even speculate that Mr Salinas' fraudulent actions would have gone unpunished had TV Azteca not been cross listed on the NYSE.

The weakness of the formal legal system is usually identified as the main culprit in discussions about the comparative underdevelopment of stock markets in emerging countries. The rationale behind this argument seems straightforward. If the formal legal system does not support the enforcement of rules on disclosure and investor protection, controlling shareholders will have room to misrepresent the firm's financial prospects and seize a disproportionate amount of the firm's output.[284] This will lead investors to discount the price paid for the firm's shares in order to account for the opportunism of insiders.[285]

Moreover, investors will probably be unable to distinguish firms in which controlling shareholders intend to behave opportunistically from those in which they do not. This uncertainty will drive the investors to apply a discount to the shares issued by all listed firms.[286] The discounting strategy followed by investors increases the cost of capital across the board and makes it unattractive for *good* firms to carry out public

283 C Doidge and others, 'Private Benefits of Control, Ownership and the Cross-listing Decision' (2009) 64 J FINANCE 425, 466. B Black and R Kraakman, 'A Self-enforcing Model of Corporate Law' (1996) 109 HARV L REV 1924.

284 This issue goes back to the correspondence between arm's length and market-based finance explained in the previous Chapter. Arm's length relations are based on the enforcement of explicit agreements such as contracts and legal rules. If arm's length finance is not supported (in this case, concerning disclosure and investor protection), there will be few limits (at least in theory) to the ability of controlling shareholders to expropriate minority investors. However, relationship-based interactions can also work to set limits to expropriation, which may provide support for the operation of stock markets. This last point is taken up in Chapter IV.

285 B Black, The legal and institutional preconditions for strong securities markets (2001) 48 UCLA L Rev 781, 832.

286 Id. The negative effects of adverse selection were initially documented (although in a different context) in G Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 QJECON 488, 500.

offerings, as they will receive only a low price for the shares they sell in public markets. The ultimate outcome of this sequence of events may be seen in stock markets across most developing nations: few listed firms and consistently low trading volumes.

This Section analyses the adverse selection problem that lies at the heart of the discounting strategy usually followed by investors in emerging countries.[287] Although political, economic and cultural factors have a hand in the development of stock markets, the problem of adverse selection has been singled out as one of the obstacles that must be overcome to accomplish this goal. The discussions below take a close look at adverse selection in the context of emerging nations as a first step to understand the mechanisms that may be most effective in dealing with this type of market failure.

A. The impact of controlling shareholders on firm value

Ricardo Salinas, the controlling shareholder of TV Azteca, has stated publicly that his self-serving actions do little to reduce the profits that outside investors collect from firms under his control.[288] Although not everybody is prepared to agree with Mr. Salinas on this point, his frame of mind draws attention to a problem commonly associated with minority equity investments in developing nations.[289] As these jurisdictions impose few formal restraints on the behaviour of insiders in listed firms, majority shareholders have room to appropriate firm value, to the detriment of outside investors.[290]

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287 The negative effects of adverse selection were initially documented (although in a different context) in G Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 QJECON 488, 500.

288 M Caruso-Cabrera (2009).

289 G Smith, 'A Bunch of Angry Mexican Shareholders' *Businessweek* (28 June 1999).

290 JC Coffee, 'Law and the Market: The Impact of Enforcement' (2007) 156 U PA L REV 244.

Mr. Salinas was not, however, entirely off the mark. Controlling shareholders are not always rogue insiders with a taste for prodigality and they usually bring sizable benefits to firms under their control. Outside investors may capitalize on this extra value without exerting significant efforts or, in other words, free ride on the benefits brought about by an insider. It has even been suggested that controlling shareholders are entitled to some compensation for the benefits they generate for the firm, as explained in further detail below.[291]

This Chapter sets out the different channels through which controlling shareholders can influence firm value. This will lead into a discussion of the adverse selection problem that arises in stock markets. As mentioned earlier, the ability of a particular jurisdiction to deal with this market failure is considered to be an important factor in the development of capital markets. The discussions below set the stage for an explanation of the mechanisms that can shape the behaviour of insiders so as to provide solutions to the problem of adverse selection.

(i) The negative impact of insiders on firm value

For several decades now, the dominant theme in corporate governance circles has been the agency relation between insiders and outsiders. Controlling shareholders, the insiders of firms with concentrated ownership, have financial incentives to appropriate firm value to the detriment of outside shareholders.[292] This situation follows naturally

291 RJ Gilson and A Schwartz, Constraints on private benefits of control: Ex ante control mechanisms versus ex post transaction review, (2012) http://ssrn.com/abstract=2129502

292 This divergence of interests gives rise to an agency problem between controlling parties and minority shareholders. J Armour, H Hansmann and R Kraakman, 'Agency Problems and Legal Strategies' in R Kraakman and others (eds), *The Anatomy of Corporate Law* (OUP, Oxford 2009) 35; P Davies, *Introduction to Company Law* (OUP, Oxford 2002) 216.

after a firm takes on minority investors. The founders of a firm that goes public dilute their equity holdings in order to collect outside resources and shed firm-specific risk.[293] As their stake in the firm's cash flows falls, these insiders will have more incentives to increase their wealth by capturing private benefits instead of sharing the firm's output with minority investors.[294] Insiders in developing nations almost invariably retain voting control, which enhances their ability to conduct the firm's business in a manner that favours the extraction of private benefits.

From an entrepreneur's perspective, the nature of private benefits of control can vary significantly.[295] For example, these benefits can be realized through the diversion of corporate assets, increases in social standing or even when succession is smoothly accomplished in a family firm. Perhaps this diversity explains why scholars have devoted considerable efforts to fit private benefits into manageable categories.[296] For the sake of simplicity, this paper uses a loose taxonomy that looks at the different channels through which entrepreneurs capitalize on private benefits. These channels can be grouped into two major categories: tunnelling and amenity potential.[297]

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293 A Gomes, 'Going Public Without Governance: Managerial Reputation Effects' (2000) 55 J FINANCE 634.

294 A Shleifer and RW Vishny, 'A Survey of Corporate Governance' (1997) 52 J FINANCE 737, 783; MC Jensen and WH Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 J FINAN ECON 305, 360. For additional discussions, see P Roosenboom and W Schramade, 'The Price of Power: Valuing the Controlling Position of Owner-managers in French IPO Firms' (2006) 12 J CORP FINAN 270, 295.

295 RJ Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy' (2006) 119 HARV L REV 1641, 1679; RJ Gilson and JN Gordon, 'Controlling Controlling Shareholders' (2003) 152 U PA L REV 785, 843.

296 A Pacces, 'Control Matters: Law and Economics of Private Benefits of Control' ECGI Working Paper No.131/2009 http://ssrn.com/abstract=1448164

297 Although this overlaps to some extent with the traditional pecuniary-nonpecuniary division, the tunnelling/amenity potential classification may perhaps provide a clearer conceptual distinction between the different forms of private benefits of control.

Tunnelling includes any transfer of a firm's resources to its controlling shareholder.[298] Private benefits of this nature fit into sub-groups that hint at what is being taken from the firm, namely, cash flows, assets or equity.[299] The first class includes activities that draw out from the firm's yearly cash flows without affecting its long-term productive assets, such as transfer pricing, loans to insiders and high executive compensation.

The second category, asset tunnelling, refers to the sale or purchase of key assets under conditions that are disadvantageous to the firm. Asset tunnelling can take the form of self-dealing transactions in which the firm acquires a major tangible or intangible asset at a value above its market price or sells it for less than its proper value, in order to benefit the controlling shareholder. It also includes investments in affiliate entities that are made under conditions unjustifiably favourable to the recipient firms.

The category of equity tunnelling encompasses transactions that 'increase the controller's share of the firm's value, at the expense of minority shareholders, but [do] not directly change the firm's productive assets'.[300] This third category includes the dilution or freezing-out of minority shareholders and insider trading. Under any of its multiple forms, tunnelling will result in a transfer of resources that increases the wealth of a controlling shareholder without a proportional allocation of such resources amongst outside investors.

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298 For discussions on tunnelling, see V Atanasov, B Black and C Ciccotello, 'Unbundling and Measuring Tunnelling', University of Texas Law and Economics Working Paper No. 117/2008 http://ssrn/com/abstract=1030529; S Johnson and others, 'Tunnelling' (2000) 90 AMER ECON REV 22, 27.

299 V Atanasov, B Black and C Ciccotello (2008).

300 Id.

Amenity potential, the second major channel through which private benefits can be realized, refers to the personal satisfaction or enjoyment that entrepreneurs obtain from exercising control over a firm.[301] Amenity potential has been described as the psychic returns that come with the ability to use a firm's resources 'to suit one's personal preferences'.[302]

Many examples can be found of private benefits that come in the form of amenity potential.[303] The most frequently cited ones arise in the field of professional sports clubs, mass communications conglomerates and real estate firms.[304] For instance, the allure of holding the reins at media powerhouses such as *The New York Times* or *Le Monde* is often mentioned in the context of amenity potential.[305] However, amenities of the kind discussed here are not always tied to these exceptional circumstances. Other, more common, examples include the social and political clout that flows to the controlling

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301 For discussions on amenity potential, see TM Zellweger and JH Astrachan, 'On the Emotional Value of Owning a Firm' (2008) 21 FAM BUS REV 347, 363; RJ Gilson (2006); O Ehrhardt and E Nowak, 'Private Benefits and Minority Shareholder Expropriation' EFA 2003 Annual Conference Paper No. 809/2003 http://ssrn/com/abstract=423506; H Demsetz and K Lehn (1985).

302 H Demsetz and K Lehn (1985) 1162. Others mention the value of '[determining] the physical appointments of the office, the attractiveness of the office staff, the level of employee discipline, (…) [acquiring] a larger than optimal computer to play with, or [the] purchase of production inputs from friends' (MC Jensen and WH Meckling (1976) 11). RJ Gilson (2006) suggests the following definition: 'forms of psychic and other benefits of control that… involve no transfer of real company resources' (at 1663, 1664).

303 PA Gompers, J Ishii and A Metrick, 'Extreme Governance: An Analysis of Dual-Class Firms in the United States' (2010) 23 REV FINAN STUD 1085); J Helwege and F Packer, 'Private Matters', BIS Working Paper No. 266/2008 http://ssrn/com/abstract=641402 4; RJ Gilson (2006); JC Coates (2004); H Deangelo and L Deangelo, 'Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock' (1985) 14 J FIN ECON 33, 69; H Demsetz and K Lehn (1985).

304 RW Masulis, PK Pham and J Zein, 'Family Business Groups Around the World: Costs and Benefits of Pyramids' ECGI Finance Working Paper No. 240/2009 http://ssrn/com/abstract=1363878, 36; H Demsetz and K Lehn (1985) 1162.

305 JC Coates (2004). Another frequently used example set in the US context refers to the personal satisfaction felt by the owner of a team that wins the World Series of baseball. H Demsetz and K Lehn (1985).

parties of successful firms.[306] Studies also suggest that entrepreneurs find satisfaction in the flexibility, autonomy and greater job security of self-employment.[307] The power to map out a company's business strategy is also mentioned as a valuable psychic advantage that attaches to control.[308]

Of the two main channels described above, tunnelling is perhaps the most visibly damaging way of extracting private benefits of control. The highly noticeable effect that this behaviour can have on a firm's financial statements has made it an easy target for scholarly attention and regulatory initiatives.[309] In fact, asset tunnelling through self-dealing transactions—which often has a clearly measurable monetary impact on the firm's balance sheet—is deemed reprehensible in many jurisdictions. Equity tunnelling through the dilution of minority shareholders is also prone to being singled out and declared objectionable. The subtler art of cash flow tunnelling may be harder to detect and proscribe. In fact, activities such as transfer pricing and high executive compensation have traditionally given policymakers a hard time.[310]

The pursuit of amenities can also impose a burden on listed firms.[311] In fact, majority shareholders often resort to tunnelling to enhance the psychic rewards of holding

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306 BR Cheffins (2008) 63; TM Zellweger and JH Astrachan (2008); M Burkart, F Panunzi and A Shleifer, 'Family Firms' (2003) 58 J FIN 2168; K Rydqvist, 'Dual-class Shares: A Review' (1992) 8 OXFORD REV ECON POL 45, 57.

307 G Hundley, 'Why and When Are the Self-Employed More Satisfied with Their Work' (2001) 4 IND RELAT 293, 316.

308 E Mueller, 'Benefits of Control, Capital Structure and Company Growth' (2008) 40 APPL ECON 2721, 2734.

309 For a review of the available literature, see V Atanasov, B Black and C Ciccotello (2008).

310 V Atanasov, A Boone and D Haushalter, 'Is there shareholder expropriation in the US? An analysis of Publicly Traded Subsidiaries' (2008) 45 J FIN QUANT ANAL 1, 26.

311 It is theoretically possible for blockholders to derive 'pure' amenity potential from holding control over a listed firm. In this case, the psychic rewards enjoyed by the insider would not entail the misallocation of the firm's resources or their transfer to the controller. To this extent, 'pure' amenity rewards can arguably be brought to fruition without any costs being imposed on investors.

control.[312] An entrepreneur might, for instance, hire an incompetent or unqualified relative to form part of the firm's management team.[313] Another case in point could involve pet projects that cater to the blockholder's affinities but inefficiently allocate the company's cash flows. A politically active entrepreneur might even decide to employ the firm's resources to back a losing candidate in local elections.[314] In all the previous examples, the prospect of capturing psychic benefits induces insiders to make decisions that impact negatively on the firm's economic outlook.

(ii) The positive impact of insiders on firm value

Even if the extraction of private benefits imposes a cost on listed companies, it is also frequent for insiders to have a positive impact on firm value.[315] In fact, controlling shareholders have strong incentives to behave in ways that redound to the benefit of the firm.[316] The large share that these parties retain in the company's cash flows makes it rational for them to maximize firm value, particularly when substantial tunnelling is not

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See RW Masulis, PK Pham and J Zein (2009); RJ Gilson (2006) 1665; CG Holderness, 'A Survey of Blockholders and Corporate Control' (2003) 9 ECON POL REV 51, 64.

312 RJ Gilson (2006); O Ehrhardt and E Nowak (2003).

313 TY Yen and P André, 'Ownership Structure and Operating Performance of Acquiring Firms: The Case of English-origin Countries' (2007) 59 J ECON BUS 382.

314 There might be grounds to hold that backing a *winning* candidate is not wasteful behaviour. See RJ Gilson (2006) 1665, n 68.

315 The discussions about the potential benefits of controlling shareholders is relevant to the extent that it can inform policy efforts designed to promote stock market development in emerging countries. This issue will be revisited in Chapters III and VI. It must also be noted that the main point of comparison for the analysis made in this Section is not a world with zero agency costs, but a system of dispersed share ownership in which directors and managers hold control over corporate affairs.

316 E Croci and D Petmezas, 'Minority Shareholders' Wealth Effects and Stock Market Development' (2009) 34 J BANKING FINANCE 681, 694; A Shleifer and RW Vishny, 'Large Shareholders and Corporate Control' (1986) 94 J POLIT ECONOMY 461, 488.

an option.[317] In this context, the lion's share of the firm's profits can only be reached through dividend distributions, which may push controlling shareholders to enhance firm value in ways that increase the amount of available dividends.

Controlling shareholders may also have incentives to enhance firm value even if substantial tunnelling is feasible. This often happens when these parties wish to protect the firm as a repository of private benefits of control.[318] For example, controlling shareholders can add to firm value in order to preserve future tunnelling opportunities. Insiders in control of business groups may value firms with high cash flow yields since, in a moment of necessity, vital resources could be shifted (i.e. tunnelled) to other liquidity-constrained entities.[319] This might lead a controlling shareholder to support the continued existence of cash cows as repositories of future tunnelling opportunities.

Insiders may also have incentives to enhance firm value in order to preserve their amenity potential. A case in point would be the controlling shareholder of a major conglomerate in a developing nation who can procure significant social and political rewards from exercising control over the business group.[320] The influence of some individuals in local circles may be closely linked to their position as the controlling shareholders of a dominant group or even just a large firm. If more efficient competitors gain ground from this enterprise, force it out of the market or—worse still—drive it into

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317 A Shleifer and RW Vishny (1997). Since controlling shareholders do not face the same coordination problems of dispersed shareholders, they are able to act on these incentives to enhance firm value, through the channels described further below.

318 Firms have been described as repositories of private information, intellectual property and reputation. RD Cooter and HB Schaefer (2010); RJ Gilson (2007). From the exclusive viewpoint of a majority shareholder, firms can also be seen as repositories of private benefits of control.

319 E Friedman, S Johnson and R Mitton, 'Propping and Tunnelling' NBER Working Paper No. 9949/2003 http://www.nber.org/papers/w9949.pdf 5.

320 See discussions in Chapter VI.

bankruptcy, the controlling shareholder's ascendancy may vanish overnight. This individual may therefore be ready to go to great lengths to ensure the continued success of the firm or group of firms.[321]

The incentives described above can move a controlling shareholder to enhance firm value through several different channels. It is widely assumed, for instance, that these parties can act as monitors to mitigate the agency problem that exists between managers and shareholders.[322] The voting power carried by their equity stakes enables controlling parties to remove incompetent, wasteful or dishonest managers.[323] As a result, controlling shareholders are expected to reduce the scope of managerial opportunism, which may improve the firm's economic outlook.[324]

Aside from their role as management watchdogs, controlling parties can also increase firm value by directly performing managerial functions.[325] In certain cases, the

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321 The founder of a successful business enterprise may also be committed to maximize firm value due to idiosyncratic motivations and endowment effects, which can be particularly strong if the company bears the founder's name or operates within an industry that appeals to her personal inclinations. This founding party—who obtains considerable psychic rewards from the continued success of the firm—can also have a large stake in enhancing its future prospects. To the extent this adds value to the firm, outside investors can benefit from the founder's presence. Consider also the head of a family firm who derives substantial amenity potential from securing transgenerational wealth and consolidating family ties (see Chapter IV). The collapse of the firm, which may be brought about by excessive tunnelling or inefficient-decision making—or both—will wipe out the amenities captured by the controlling family member. Accordingly, the preservation of these private benefits may drive this individual to commit heavily to the firm's ongoing success.

322 CG Holderness, 'Do Differences in Legal Protections Explain Differences in Ownership Concentration?' (2008) http://ssrn.com/abstract=1104678; CG Holderness and DP Sheehan, 'Constraints on Large-Block Shareholders' in R Morck (ed) *Concentrated Corporate Ownership* (University of Chicago Press 2000) 139; A Shleifer and RW Vishny 'Large Shareholders and Corporate Control' (1986) 94 J POLIT ECONOMY 461, 488.

323 B Becker, H Cronqvist and R Fahlenbrach, 'Estimating the Effects of Large Shareholders Using a Geographic Instrument' (2010) http://ssrn.com/abstract=1101012; A Shleifer and RW Vishny (1997). Moreover, there is evidence that the monitoring activities of family blockholders on nonfamily CEOs have a positive effect on firm value. B Villalonga and R Amit (2010).

324 TY Yen and P André (2007) 382.

325 Controlling shareholders are more often managing insiders than outside monitors (CG Holderness (2008).

presence of a majority shareholder at the firm's helm might even be of critical importance to the firm's success. To this effect, the identity of controlling parties may be of some relevance to determine whether or not managing shareholders will bring value to the firm.[326] In addition, founding shareholders may run a firm more efficiently than outside managers due to their historical presence and better knowledge of the company's technology.[327]

Controlling shareholders can also add to firm value through the behaviour known as *propping*. Propping is the antithesis of tunnelling.[328] It mainly refers to the transfer of a controlling shareholder's private resources or cash flows from other controlled entities into a firm with outside investors.[329] Propping can take place through capital contributions, loans, self-dealing that favours the firm or, perhaps more interestingly, through covert transactions.[330] This behaviour is commonly seen in firms that suffer

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326 An illustrative example may be found in the case of Warren Buffet and Berkshire Hathaway. See C Sutton, 'Berkshire Hathaway ranks number one in reputation', *CNN Money* (5 April 2010) and G Martin and J Puthenpurackal, 'Imitation is the Sincerest Form of Flattery: Warren Buffet and Berkshire Hathaway' Working Paper 2008 http://ssrn.com/abstract=806246. On the relevance of an insider's identity to firm value, see RC Anderson, A Duru and DM Reeb (2009) 206; D Sraer and D Thesmar (2007) 709.

327 The founders of a firm might indeed have a superior know-how of its commercial activities which can be capitalized when they also forms part of management. RC Anderson, A Duru and DM Reeb, 'Founders, Heirs and Corporate Opacity in the US' (2009) 92 J FINAN ECON 207; RC Anderson and DM Reeb (2003) 1305; D Sraer and D Thesmar, 'Performance and Behaviour of Family Firms: Evidence from the French Stock Market' (2007) 5 JEEA 709, 751.

328 Perhaps for this reason it has been labelled as 'reverse tunnelling'. YE Riyanto and LA Toolsema, 'Tunnelling and Propping: A Justification for Pyramidal Ownership' (2008) 32 J BANKING FINANCE 2178, 2187.

329 J Siegel and P Choudhury 'A Reexamination of Tunnelling and Business Groups: New Data and New Methods' Harvard Business School Working Paper No. 072/2010 http://www.hbs.edu/research/pdf/10-072.pdf; H Almeida and D Wolfson (2006); E Friedman, S Johnson and R Mitton (2003).

330 Controlling parties may want to hide propping activities for many reasons, including tax avoidance and the management of market expectations. E Friedman, S Johnson and R Mitton (2003).

negative shocks that destabilize their commercial or industrial activities.[331] As exemplified by cases from Eastern Asia and Latin America, controlling shareholders in developing nations often prop up distressed firms in order to preserve them as going concerns.[332]

Propping has mainly been attributed to controlling shareholders that expect to reap future profits through tunnelling. By channelling fresh resources into failing firms, these individuals are arguably investing in future opportunities to expropriate outside investors. However, the examples mentioned above also hint at the possibility that propping can take place as a means to protect the firm's amenity potential. In either case, controlling shareholders would be treating the firm as a repository of private benefits of control. This may lead them not only to rescue distressed firms, but also to maximize firm value.[333]

Finally, it may even possible for the firm to realize spillover benefits from actions of the controlling party that are not specifically aimed at maximizing firm value. An example of indirect benefits can be found in amenity pursuits that ultimately redound to the firm's advantage. For instance, the political influence wielded by an entrepreneur—which is likely to be based on her control over a large business venture—can insulate the firm from the State's grabbing hand.[334] Another example is linked to the preservation of

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331 In China, 'controlling shareholders tunnel out of firms that outperform the market and prop up firms that under-perform'. YL Cheung and others, 'Tunnelling and Propping up: An Analysis of Related Party Transactions by Chinese Listed Companies' (2009) 17 PBFJ 383.

332 See YL Cheung and others (2009); YE Riyanto and LA Toolsema (2008); E Friedman, S Johnson and R Mitton (2003).

333 E Friedman, S Johnson and R Mitton (2003).

334 L Enriques (2009) 49; RJ Gilson (2006).

family control, which facilitates the creation of informal commitments with the firm's personnel and may consequently improve firm performance.[335]

Value can also be added indirectly through transactions undertaken between the firm and other entities under common control.[336] In some cases, these related party transactions are nothing more than tunnelling schemes designed to divert value away from the firm. However, business ties between several firms affiliated in complementary industries also have the potential to create synergies and reduce hold-up problems.[337] Chapter VI develops this idea in the context of Latin American *grupos*.

In sum, controlling shareholders have many ways of increasing firm value. As mentioned earlier, free-riding investors can capture a portion of this extra value, which comes at the expense of controlling shareholders, who forgo the benefits of diversification, employ efforts to monitor and discipline management, direct the firm's activities and may even prop up the firm in times of distress.[338] In the opinion of the colourful Mr. Salinas: 'I know more about this company, and the companies in general, than [minority shareholders] do. And I normally make better decisions. You know,

335 D Sraer and D Thesmar (2007). This might explain the positive effect that family control often has on firm value. For a review of the literature on this positive impact, see TY Yen and P André (2007). Moreover, family control can give ground to larger investments in firm-specific human capital by the company's non-family executives WW Bratton and JA McCahery (1999).

336 MD Ryngaert and SE Thomas, 'Related Party Transactions: Their Origins and Wealth Effects', University of Florida Working Paper 2007 http://ssrn.com/abstract=970689. Even if some value accrues to the firm due to the spillover effects mentioned here, the production of these indirect effects might happen only sporadically. It follows that the benefits ultimately realized by outside investors through this channel may not always be substantial.

337 For this to happen, several preconditions may have to be met. To be sure, it is more likely for a transaction to enhance firm value if its financial terms are fully disclosed to outside shareholders and if it is executed at arm's length, than in cases in which these conditions are not present. H Holmén and P Högfeldt (2009); T Baldenius, 'Ownership, incentives, and the hold-up problem' (2006) 37 RAND J ECON 276, 299.

338 M Becht, P Bolton and A Röell (2003); WW Bratton and JA McCahery (1999); P Bolton and EL von Thadden (1998).

sometimes we make mistakes, like everybody. But […] in terms of minority shareholders, they have had a great ride with us'.[339]

It is for the previous reasons that the private benefits of control discussed earlier are often seen as compensation for the value-enhancing activities of controlling shareholders.[340] However, controlling shareholders may be inclined to appropriate firm value in an amount that exceeds the benefits that accrue to outside shareholders from the exercise of corporate control.[341] As explained in Section 2 below, this situation may become problematic if there are few limits on the ability of controlling shareholders to extract firm value. To this effect, there is an ongoing debate concerning different ways of limiting the consumption of private benefits to 'efficient levels—where the gains from better monitoring and management exceed the PBC cost to minority shareholders'.[342] Chapters III, IV and VI discuss potential avenues towards this end.

B. The (stock) market for lemons

The previous discussion already hinted at one of the sources of the adverse selection problem that can have a negative effect on the operation of stock markets. Adverse selection arises from asymmetries of information.[343] Informed market participants make decisions that harm uninformed parties, which leads to market

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339 CNBC Transcript, Interview with Michelle Caruso-Cabrera, February 4, 2009.

340 RJ Gilson and A Schwartz (2012).

341 Id.

342 Id.

343 G Akerlof (1970).

failure.[344] In the context of listed firms, insiders have more knowledge than outside investors about the way in which they manage the firm's affairs and the impact of such behaviour on the firm's future prospects. Investors who lack sufficient information about the controlling shareholder's abilities and inclinations will find it hard to determine *ex ante* whether or not the cost of private benefit extraction will surpass the benefits tied to the controller's activities.

Investors who anticipate that the activities of a controlling shareholder will have an overall negative impact on their investment will discount the price paid for the firm's shares to account for the future loss of value.[345] However, outsiders are usually unable to distinguish between firms where excessive value will be lost to a controlling party and firms in which this will not occur. Even if the presence of a controlling shareholder has had a net positive impact for investors in the past, a change of control or in the behaviour of the controlling party is sufficient to reverse this trend. This situation makes it rational for investors to apply a discount to the shares of all listed firms.[346]

It must also be noted that a similar adverse selection problem can arise from information asymmetries concerning the firm's actual financial performance.[347] Investors require a good measure of data about a company's financial standing in order to assess the correct value of its shares. As controlling parties have incentives to embellish the firm's financial information in order to procure the highest possible price, investors may

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344 JM Kim, 'A Signalling Approach to the Adverse Selection Problem in a Mutual Fund Market', Southern Methodist University Working Paper 2010 http://people.smu.edu/jongk.

345 CG Holderness and DP Sheehan (2000).

346 B Black and R Kraakman (1996). Investors may anticipate that even firms with insiders that currently enhance firm value could in the future come under the control of an insider bent on expropriating investors, which will lead them to apply this discount across the board.

347 B Black (2001) 786.

be unable to distinguish between firms that disclose accurate information and those that do not. This situation can also move investors to follow the discounting strategy mentioned above.[348] However, this Chapter focuses mainly on the behaviour of insiders of listed firms, with only passing references to the problem of inaccurate financial disclosures.[349]

To sum up, the lack of credible information concerning the future behaviour of controlling shareholders and the firm's financial performance may lead investors to apply a discount to the shares of all firms listed in capital markets. This discounting strategy increases the cost of capital for firms that seek to raise equity through an issuance of public stock.[350] This in turn makes it financially unattractive for firms to incur in the expenses of listing in a stock exchange, particularly when internally generated funds or debt financing are available.[351] The discounting strategy also reduces the overall quality of the companies that seek a public listing, since *good* companies will not receive a fair price for the shares sold to the public.

As the number and the quality of listed firms decreases, investment options for market participants are correspondingly reduced, which depresses stock markets even

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348 JR Macey (2010a).

349 Controlling the behaviour of insiders in listed firms and allowing investors to rely on the firm's financial data are both important factors in dealing with adverse selection. The first goal, closely related to an earlier discussion on private benefits of control, is usually seen as the harder of the two. For an analysis of the reasons that explain why adverse selection tied to self-dealing is more difficult to deal with than adverse selection tied to information disclosure, see Black (2001) 805.

350 This may give insiders an additional incentive to divert value from the firm. In fact, after the firm has already been charged for diversionary practices through a discount, controlling parties may be inclined to recoup this financial loss by seizing the firm's resources.

351 K Lins (2003); JPH Fan and others, 'Expropriation of minority shareholders: Evidence from Asia' World Bank Policy Research Working Paper No. 2088/1999 http://ssrn.com/abstract=620647; B Black and R Kraakman (1996) 1922. Firms in emerging jurisdictions have historically found it cheaper to finance new projects through internally generated funds or bank finance rather than by relying on outside equity. See Chapter I.

further. This shrinks the main constituencies that would otherwise seek political support for the introduction of mechanisms that promote the development of stock markets. This sequence of events (or a 'lemons equilibrium') is usually presented as one of several obstacles to stock market growth in emerging countries.[352]

To counteract this negative cycle, it seems necessary to strike at the root of the problem, namely, adverse selection. For this purpose, the discussions above suggest that investors require strong assurances about the future behaviour of insiders and credible statements about the firm's financial performance.[353] In countries with developed stock markets, this is often accomplished through a combination of the legal system, market forces and cultural norms.[354] A strong legal system compels firms to engage in full and fair disclosure, and to a large extent limits the opportunistic behaviour of insiders.[355] Market forces can also work to the same effect, particularly with regard to the opportunism of insiders, as seen in the disciplining effects of the market for corporate control and competitive pressures from other firms.[356] Cultural norms that have been

352 B Black (2001).

353 B Black and R Kraakman (1996); B Black, Is corporate law trivial: A political and economic analysis (1990) 84 NW U L Rev 542.

354 This does not mean that insiders in developed countries are unable to extract private benefits, but rather that the channels through which this can take place are cropped down. In these jurisdictions, insiders are usually discouraged from stripping the firm's assets or diluting minority investors. Subtle cash tunnelling and other transactions specifically designed to bypass these legal strategies might, however, still be available. Available evidence suggests that empire building, executive compensation and moderate 'ordinary course of business' transactions, all of which draw from the firm's cash flows, are not unusual in developed jurisdictions such as the US and certain Member States of the EU. See V Atanasov, A Boone and D Haushalter (2008). For the US, see also R Masulis, C Wang and F Xie (2009); V Atanasov, B Black and C Ciccotello (2008) and A Shleifer and RW Vishny (1997). For the EU, see M Faccio and D Stolin, 'Expropriation vs Proportional Sharing in Corporate Acquisitions' (2006) 79 J BUS 1443.

355 J Coffee (2007).

356 M Guadalupe and F Pérez-Gonzales, 'The Impact of Product Market Competition and Private Benefits of Control' AFA Chicago Meeting Paper 2006 http://ssrn/com/abstract=890814; HG Manne, Mergers and the market for corporate control (1965) 73 J POL ECON 2, 110-120

assimilated by market participants can also encourage disclosure and prevent misbehaviour.[357]

In stark contrast, the trademark of emerging nations is precisely that most of these constraints are either absent or too weak to influence the behaviour of insiders.[358] The legal system in these jurisdictions is usually weak, as illustrated by almost every available indicator, and often particularly ineffective in the context of corporate matters.[359] At the same time, local monopolies soften competitive pressures and a significant degree of ownership concentration stifles the market for corporate control.[360] For various reasons, norms do not often encourage patterns of behaviour that can act as a constraint on corporate insiders.[361] This lack of constraints places insiders in a privileged position to expropriate investors, a problem that lies at the heart of the 'lemons equilibrium' described earlier.

To illustrate the previous point, it is useful to look at the differences in value between the shares held by controlling shareholders and those held by minority investors

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357 JC Coffee, 'Do Norms Matter? A Cross-country Evaluation' (2001) 149 U PA L REV 2151, 2177; MA Eisenberg, 'Corporate Law and Social Norms' (1999) 99 COLUM L REV 1253, 1292 and RC Ellickson, *Order Without Law: How Neighbors Settle Disputes* (Harvard University Press 1991).

358 A Dyck and L Zingales (2004); T Nenova, 'The Value of Corporate Votes and Control Benefits: A Cross-country Analysis (2003) 68 J FIN ECON 325, 351; MJ Barclay and CG Holderness, 'Private Benefits of Control of Public Corporations' (1989) 25 J FIN ECON 371, 395.

359 'Stark differences around the world in the quality of capital markets appear attributable to the fact that the lemons problem is particularly acute in countries with poorly developed legal and regulatory systems'. JR Macey, The value of reputation in corporate finance and investment banking (and the related roles of regulation and market efficiency) (2010a) 22 J APP CORP FIN 4, 22. See also JC Coffee (2007), the Rule of Law Index.

360 S Deakin, Corporate governance, finance and growth: Unravelling the relationship, (2010) ACTA JURIDICA, 218. J Glen and A Singh, Corporate governance, competition and finance: Re-thinking lessons from the Asian crisis, (2004) ESRC Centre for Business Research Working Paper No. 288.

361 One potential explanation relates to the idea that norms do not reflect investor-friendly behaviour but rather cater to the absolute dominance of controlling shareholders over 'their' firms.

across developed and emerging countries.[362] To this effect, shares that form part of a controlling block are priced at a higher value than shares held by minority investors.[363] The magnitude of these differences in value is considered to be a measure of the private benefits available to controlling parties. An often-cited paper quantifies these differences by looking at the premium paid to majority shareholders in transfers of control over listed firms in 39 countries.[364] The results of this study, summarized in Table 1, show that the variation in price between majority and minority shares is larger in emerging countries than in developed nations and particularly acute across Latin American countries. In fact, five out of the ten countries in which the control premium exceeds 25% of a firm's equity value are located in this region.

Table 1
Control premia in select countries

Country	Control premium as a percentage of equity value
Brazil	65%
Mexico	34%
Argentina	27%
Colombia	27%
Venezuela	27%

362 Studies that track private benefits in multiple countries have indeed found that entrepreneurs are better placed place to capture these rewards in emerging nations than in more developed jurisdictions. A Dyck and L Zingales (2004); T Nenova, 'The Value of Corporate Votes and Control Benefits: A Cross-country Analysis (2003) 68 J FIN ECON 325, 351; MJ Barclay and CG Holderness, 'Private Benefits of Control of Public Corporations' (1989) 25 J FIN ECON 371, 395.

363 A Dyck and L Zingales (2004). See also MJ Barclay and CG Holderness (1989).

364 Id.

Chile	18%
Peru	14%
Germany	10%
France	2%
United Kingdom	1%
United States	1%

Adapted from A Dyck and L Zingales (2004).

The results of this study and a similar one conducted in 2003 suggest that majority shareholders have more space to extract private benefits of control in emerging countries than in developed jurisdictions. [365] One way of dealing with this problem—a problem that leads to adverse selection and the lemons equilibrium—is to strengthen the constraints on the behaviour of controlling shareholders. When this task is accomplished successfully, investors will at the very least reduce the amount of the discount applied to a listed firm's shares.[366] This allows firms to receive a price closer to the fair value of the shares they issue in public markets and increases the incentives for companies to list in a stock exchange. As more and better quality firms issue shares, the number of equity investors increases, spurring political support for further improvements to the system that supports market-based exchange, thus reinforcing the whole cycle. Legal scholars point to this

[365] K Lins, 'Equity Ownership and Firm Value in Emerging Markets' (2003) 39 JFQA 159, 184.

[366] As mentioned below, legal institutions can also mitigate the information asymmetry concerning the firm's past and future performance.

'strong market equilibrium' as one of several steps required for the development of stock markets.[367]

How, then, can policymakers strengthen the constraints that can neutralize adverse selection? The World Bank and the OECD have sought to accomplish this goal in emerging countries through legal reform programmes based on the notion that investor protection rules matter for stock market development. The results of these programs in the context of Latin American countries are described briefly below and more thoroughly in Chapter VI. In Europe, where legal systems are generally stronger than in most developing countries, policymakers have attempted to stimulate the market for corporate control through harmonization measures such as the Takeover Directive.[368]

The next Section takes the view that institutions—a term described more fully below—are important to overcome adverse selection and bring about a 'strong market equilibrium'. Of course, there are many political, economic and cultural factors that can influence the development of stock markets.[369] The point made here is simply that serviceable institutions that allow investors to have credible assurances about the future

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367 B Black, The legal and institutional preconditions for strong securities markets (2001) 48 UCLA L Rev 781, 832. As explained in Chapter I, stock market development is also a function of factors such as the size of a country's economy, the nature of innovation processes and industrial structure. The creation of the conditions to deal with adverse selection will not, on its own, give way to the development of stock markets.

368 C Gerner-Beurle, D Kershaw and M Solinas, Is the board neutrality rule trivial? Amnesia about corporate law in European takeover regulation, (2011) LSE Law, Society and Economy Working Paper No. 3; L Enriques, The mandatory bid rule in the takeover directive: Harmonization without foundation, (2004) 1 EUR C FIN LAW REV 4, 440-457. Moreover, the debate as to how to facilitate the assimilation of social norms has for the most part not transcended the academic sphere. EA Posner, Law and social norms: The case of tax compliance, (2000) 86 V Law Rev 8, 1781-1819.

369 C Burhop, D Chambers and BR Cheffins, 'Is regulation essential to stock market development: Going public in London and Berlin 1900-1913', (2011) ECGI Law Working Paper No. 180; see also Chapter I.

behaviour of insiders and credible statements about the firm's financial performance can mitigate the problem of adverse selection.

2. Institutions and capital markets

Adverse selection can be a powerful obstacle to the development of capital markets in emerging countries. As explained in the previous section, when controlling shareholders have room to misrepresent the firm's financial prospects and seize an excessive portion of the firm's output, market failure will inexorably ensue. A potential solution to this problem seems to follow naturally from the way in which the issue is framed: If adverse selection originates in the ability of insiders to deal unfairly with outside investors, the introduction of legal rules that regulate the behaviour of these insiders will nip the issue at the bud.

As evidenced by more than a decade of legal reform, this deceptively simple idea has guided the efforts of policymakers across the developing regions of Latin America, Eastern Europe and Asia. This legal reform programme, set in motion by organizations such as the World Bank and the OECD, sought to introduce mainstream corporate governance mechanisms into developing countries.[370] Despite the considerable human and capital resources invested into the programme, however, the available evidence suggests that these efforts may not have been entirely successful in promoting the development of capital markets.[371]

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370 See Chapter VI.

371 See, for instance, J Armour and others, 'Law and Financial Development: What Are We Learning from Time-Series Evidence' (2010a) ECGI Law Working Paper No.148 http://www.ecgi.org/wp/wp_id.php?id=426.

Several explanations have been put forward to account for the apparent shortcomings of the legal reform programme. An influential line of criticism points to the problems of transplanting legal rules from industrialized nations into less developed countries. The imposition of foreign rules without concern for local conditions (i.e. demand for law, pre-existing political and social arrangements, macroeconomic complementarities) may be a recipe for failed legal transplants.[372] Under this view, the principal effect of the legal reform program mentioned earlier was to increase the disparity between the law in the books and the law in action, without significant improvements in the actual protection of outside investors.[373]

Another important objection raised against reform of the kind sponsored by the OECD and the World Bank challenges the notion that formal legal rules are central to the initial development of stock markets.[374] Some proponents of this approach point to the history of industrialized nations, where capital markets grew at a significant pace *before* legal rules for disclosure and investor protection were set in place.[375] Available evidence suggests that firms and individuals once relied on informal relations of 'trust' to carry on

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372 D Berkowitz, K Pistor and JF Richard, 'The transplant effect' (2003) 51 AM J COMP L 1, 163-203.

373 Roscoe Pound first drew the distinction between the 'law in the books' and the 'law in action' in a 1910 essay (see Law in the Books and Law in Action, 44 AMER L REV 12). In his words, 'if we look closely, distinctions between law in the books and law in action, between the rules that purport to govern the relations of man and those that in fact govern them, will appear, and it will be found that today also the distinction between legal theory and judicial administration is often a very real and a very deep one' (Id. at 15). In the context used in the main text above, the distinction is drawn between the codified rules that govern the behaviour of insiders in listed firms (law in the books) and the actual manner in which these insiders behave as a result of the absolute lack of enforcement of most of these rules (law in action).

374 C Mayer, Trust in financial markets, (2008) 14 EUROP FIN MAN 4, 617-632.

375 C Burhop, D Chambers and BR Cheffins (2011); BR Cheffins *Corporate Ownership and Control: British Business Transformed* (OUP, Oxford 2008; JC Coffee, 'The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control' (2001) 111 YALE L J 1, 82.

market-based exchange in Germany, Japan, the UK and the US.[376] These relations were supported by 'informal' mechanisms that operated alongside the state-backed legal system. Only after stock markets had achieved an appreciable level of development were effective legal mechanisms introduced in these jurisdictions.[377]

These criticisms illustrate the difficulty of designing policies that can effectively contribute to the development of stock markets in emerging countries. They also suggest that we do not yet have a complete picture of the framework that supports market-based finance across different jurisdictions. In fact, emerging countries *do* have operational stock markets with varying levels of IPO activity and secondary trading. This is true even across Latin American nations, where the infrastructure for the enforcement of disclosure and investor protection rules is mostly defective.

How can one reconcile this fact with the prevailing view on the operation of stock markets explained earlier?[378] As discussed in the previous section, one answer to this question is that investors discount the price of shares acquired in stock markets to account for the future diversion of firm assets by controlling shareholders. Nonetheless, this presupposes that there is a limit to the amount of firm resources that insiders can appropriate, for absent this limit the value of any outside holdings in the firm would be zero.[379]

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376 C Burhop, D Chambers and BR Cheffins (2011); F Allen and others, How important historically were financial systems for growth in the UK, US, Germany and Japan?, (2010) Working Paper, available at http://fic.wharton.upenn.edu/fic/papers/10/10-27.PDF; C Mayer (2008).

377 BR Cheffins, 'Law as Bedrock: The Foundations of an Economy Dominated by Widely-held Public Companies' (2003) 23 OXFORD J LEGAL STUD 11; J Markham, *A Financial History of the United States* (vol. II, M.E Sharpe, New York 2002); JC Coffee (2001) 80.

378 See RJ Gilson, Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange, (2007) 60 STAN L REV 636.

379 To paraphrase RJ Gilson (2007), why are there minority investors in jurisdictions where controlling shareholders have no legal limits on their ability to appropriate the firm's resources?

One plausible explanation for the existence of this limit is that even the most lethargic state will be forced to intervene in extreme cases of embezzlement. At the same time, some elements of a country's legal infrastructure may be less dysfunctional than others. For instance, regulators can supply a measure of enforcement even if the local judiciary is inoperative with regard to corporate issues.[380] Arbitration and other mechanisms for alternative dispute resolution may also have a hand in providing at least a minimum degree of investor protection in this context. 'Self-enforcing' corporate rules (i.e. super-majority requirements, approval of conflicted transactions by outside shareholders or independent board members) could in theory protect investors even in the complete absence of corporate litigation.[381]

However, even these factors may be insufficient to account for the continued presence of minority shareholders in Latin American listed firms. The shortcomings of local judiciaries are well known. Regulators in the region usually face obstacles that limit their sphere of influence, including insufficient financial and human resources to supervise listed firms, and potential capture by interest groups. Arbitration is an expensive solution reserved almost exclusively for disputes between affluent parties, while mediation is useless without a credible threat of formal enforcement. Even self-enforcing rules, a regulatory option that has been tried and tested in several transition economies, require a solid governmental infrastructure to work properly. Other forces

[380] HE Jackson and MJ Roe, Public and private enforcement of securities laws: Resource-based evidence, (2009) 93 J FIN ECON 1; F Reyes, Corporate governance in Latin America, (2008) 29 INTER-AMERICAN LAW REV 207.

[381] J Armour, Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment' ECGI Law Working Paper No. 106/2008; B Black and R Kraakman, 'A Self-enforcing Model of Corporate Law' (1996) 1925.

may therefore be at work to support market-based exchange in these jurisdictions, either individually or jointly with a moderately functional legal system.

An interesting answer to this riddle concerns the existence of informal institutions that promote relations of trust between firms and investors.[382] Informal institutions are simply the mechanisms that support cooperative behaviour outside of the official system, as more thoroughly defined below.[383] The central informal institution analysed here is a system of reputational intermediation that operates between gatekeepers, controlling shareholders and outside investors.[384] The 'trust' generated by this informal institution can support market-based exchange even when legal rules are under-enforced.

This section sets out some preliminary remarks as to how formal and informal institutions can mitigate the effects of adverse selection through their influence on the behaviour of controlling shareholders.[385] Although each institution is analysed separately in the following Chapters, it is often the case that both operate together in developing and emerging nations. When a state's infrastructure is weak, as in the cases mentioned above, the actual performance of legal rules may be impaired due to incomplete enforcement and the lack of an ongoing process to revise and update the law. Informal institutions that encourage cooperative behaviour in capital markets can supplement the action of legal rules in this context. This also holds true across the industrialized world, where even the

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382 This issue is tied to the link between relationship-based and market-based finance that was explained in Chapter I. Relationship-based interactions provide the basis for the operation of informal institutions that set a limit on the ability of controlling shareholders to expropriate investors. The existence of this limit provides support for market-based finance.

383 G Helmke and S Levitsky, Informal institutions and comparative politics: A research agenda, (2004) 2 PERSPECTIVES IN POLITICS 4, 725-740.

384 Norms may fit within the definition of 'institutions' used in this Chapter to the extent that they embody the 'rules of the game' that determine the behaviour of individuals.

385 The main emphasis is placed on the way in which these insiders conduct the firm's affairs, with only passing reference to the problem of financial disclosure.

strongest state will be unable to fully constrain the behaviour of insiders through the rule of law. It follows that formal and informal institutions are both important instruments in controlling the behaviour of corporate insiders.

A. A primer on formal and informal institutions

The first challenge posed by the study of institutions is semantic. The term 'institutions' is used in such a wide array of disciplines—from anthropology to criminology—that it is not easy to come up with a definition that fits every context.[386] Some definitions rely on examples of what an institution might look like ('an established law, practice or custom'),[387] while others employ broad statements that allow the term to be used across different disciplines ('systems of established and prevalent social rules that structure social interactions').[388]

The institutions studied in this Chapter are related to what New Institutional Economists refer to as the 'humanly devised constraints that shape human interaction'.[389] Although this definition seems to imply that institutions arise as a result of deliberate efforts to constrain human behaviour, institutions can also 'evolve over time', that is, in the absence of a clear teleological effort to create them.[390] Accordingly, for the purposes of this dissertation, institutions are simply the mechanisms that influence the behaviour of

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386 GM Hodgson, What Are Institutions? (2006) 40 J ECON ISS 1.

387 J Simpson and E Weiner (eds), Oxford English Dictionary (Clarendon Press, 2nd ed, 1989).

388 GM Hodgson (2006).

389 A distinction is usually drawn between institutions (i.e. the 'rules of the game'), and organizations (i.e. 'groups of individuals bound by some common purpose to achieve objectives'), which may include political parties, firms, universities or clubs. Institutions and organizations interact with each other in different ways: 'Both what organizations come into existence and how they evolve are fundamentally influenced by the institutional framework. In turn they influence how the institutional framework evolves'. DC North (1990) 4-5.

390 Id.

firms and individuals in the context of capital markets. This broad definition, developed more fully below, may include legal rules enacted by the state, as well as the system of reputational intermediation discussed earlier.

The theory of institutions has come to play a prominent role in our understanding of economic growth and development. Institutions are thought to have a hand in economic development to the extent that they foster productive activity, an idea that has been tested empirically over the past two decades.[391] Although there is now compelling evidence to support the existence of a relation between institutions and economic growth, much less is known about the process of institutional reform.[392] Significant efforts have been put to the task of improving institutions in the developing world without truly positive results.[393] Despite these setbacks, commonly attributed to misguided policies and a poor understanding of the diversities of emerging countries, the idea that institutions can promote development still stands as one of the pillars of modern economic thinking.[394]

Institutional theory also informs our current understanding of how stock markets initially develop and reach maturity.[395] Although many institutions can influence the growth of capital markets, this dissertation examines only the small subset that can mitigate adverse selection by setting limits to the behaviour of insiders in listed firms and by allowing investors to rely on the firm's financial data. The following discussions focus

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391 M Mota, Path dependence, development, and the dynamics of institutional reform (2009) University of Toronto Legal Studies Research Series No. 4.

392 W Easterly, Institutions: Top down or bottom up? (2008) 98 AMER ECON REV 2, 95.

393 M Mota (2009).

394 D Rodrik, Second-best institutions (2008) 98 AMER ECON REV 2, 100.

395 B Black (2001).

on two different kinds of institutions that may accomplish this goal: formal and informal institutions.

As understood here, *formal institutions* are the components of a system, vested with official authority, that explicitly regulates the behaviour of firms and individuals in capital markets. The authority is 'official' to the extent it emanates directly from the state (i.e. legal rules enacted by the legislator) or is derived from the state's acquiescence (i.e. rules issued by self-regulatory organizations). The regulation is 'explicit' to the extent it involves written provisions that govern the behaviour of market participants, including penalties for non-compliance.

The main objectives of the formal institutions studied here are to limit the excessive appropriation of firm value by insiders in listed firms and to ensure proper disclosure of the firm's finances to the public. If formal institutions are to accomplish these goals, external agents must be available to design and enforce the rules that govern the behaviour of market participants. The discussions below and in the following Chapters examine how the state—and in some cases self-regulatory organizations (SROs)—can assume this role through the enactment of substantive and procedural rules, including corporate and commercial laws, securities regulation, tax codes and bankruptcy statutes, as well as the rules issued and enforced by SROs.[396]

When the state administers formal institutions, the task of designing and enforcing rules is usually distributed among the different branches of government following the standard allocation of powers in western democracies. Legislators design, promulgate and, from time to time, amend rules of a general nature. The judiciary creates rules in

[396] Tax and creditor protection rules have an impact on the extraction of firm value by insiders. See V Atanasov, B Black and C Ciccotello, Self-dealing by corporate insiders: Legal constraints and loopholes (2011), Northwestern University Law and Economics Research Paper No. 7.

some systems and, more generally, enforces legal rules at the behest of interested parties, including investors, firms and their officers and employees. The executive branch, through its regulatory authority, enacts technical rules and enforces the law mostly on its own initiative. Although different legal traditions can allocate these responsibilities differently due to their particular system of government or local political arrangements, most jurisdictions follow the structure laid out here.

SROs can also administer formal institutions in the context of capital markets. In the cases analysed in the following Chapters, SROs obtain 'official' authority to regulate listed firms through the state's implicit or explicit authorization, as well as from private agreements executed with their members.[397] This does not necessarily mean that SROs should be considered governmental actors. To be sure, there is an ongoing debate concerning the nature of the authority exercised by SROs in capital markets,[398] as well as the ability of courts to review decisions made by these organizations.[399] The claim made here is simply that SROs can support formal institutions in modern capital markets

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397 Self-regulatory organizations may also operate without the state's acquiescence. This is the case of the Assembly of Merchants that regulated the cross-border activities of Julfan Merchants in the absence of what is presently understood as a 'state' (see Chapter V), supranational entities such as the International Criminal Court which derives authority from the Rome Statute treaty (see http://www.icc-cpi.int/Menus/ICC/About+the+Court/) or even criminal organizations with their own set of rules (i.e. the Italian *Cosa Nostra* or the Colombian *Medellin Cartel*).

398 SJ Cleveland, The NYSE as State Actor? Rational Actors, Behavioral Insights and Joint Investigations, (2006) 55 AMER UNIV L REV 1, for a detailed description of this debate in the US).

399 The authority of the UK's Takeover Panel—an SRO until 2006—to regulate and discipline listed firms was reviewed in the *Datafin* case decided in 1987 (R v Panel on Takeovers and Mergers, ex parte Datafin plc and another (Norton Opax plc and another intervening) [1987] 1 QB 815). In this case, the Court of Appeals determined that it had 'jurisdiction to entertain applications for the judicial review of decisions of the panel' (Id at 839). However, the scope of judicial review over the Panel's decisions was restricted to declaratory judgments 'regarding future conduct and would not have any consequences for the validity of decisions which have been taken' (J Armour and D Skeel, Who Writes the Rules for Hostile Takeovers and Why? The Peculiar Divergence of US and UK Takeover Regulation, (2006) ECGI Law Working Paper No. 73.

because the state's implicit or explicit acquiescence grants SROs the 'official' authority to regulate listed firms.[400]

In use of this 'official' authority, the SROs that operate in capital markets often set out written rules and serve as the central body for their enforcement among listed firms. The Financial Industry Regulatory Authority in the United States, for instance, takes on this role with respect to brokers and registered securities representatives.[401] In the UK, the Panel on Takeovers and Mergers—until recently an SRO—administers the City Code on Takeovers and Mergers, which sets out rules for the protection of investors in listed firms.[402] Stock exchanges can also regulate the behaviour of listed firms, as exemplified by the New York Stock Exchange's adoption of special listing rules and the imposition of fines and forced delistings for infractions of these rules.[403]

Informal institutions are mechanisms outside of the official system that encourage cooperative behaviour in capital markets. Informal institutions promote cooperative behaviour because they generate 'trust' between market participants, that is, they give rise to mutual expectations as to the future behaviour of these parties.[404] In this context, individuals can 'trust' each other because informal institutions tie their welfare to their

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400 In the *Datafin* case mentioned earlier (see n. 34), the English Court of Appeals found that the Takeover Panel benefited from a sort of implicit state acquiescence to regulate listed firms. The Court initially reviewed the Panel's authority on the grounds that it had 'no statutory, prerogative or common law powers and it is not in contractual relationship with the financial market or with those who deal in that market' (*id* at 825). At the same time, however, the court made clear that although the Panel had no 'visible means of legal support', it did have 'indirect support' (*id* at 834).

401 See http://www.finra.org/AboutFINRA/

402 J Armour and D Skeel (2006).

403 See http://nysemanual.nyse.com/lcm/

404 Absent this feature, the term informal institutions could encompass almost any sort of recurrent behaviour. See G Helmke and S Levitsky (2004) for a more detailed discussion concerning the definition of the term 'informal institutions'.

observable actions. While cooperation leads to rewards, deviations from the expected pattern of behaviour trigger a sanction beyond any official penalties imposed by the state or SROs.[405]

This dissertation deals exclusively with the informal institution known as reputational intermediation.[406] Reputational intermediation is based on the existence of repeat players in capital markets who can instigate relations of 'trust' between listed firms and potential investors.[407] These intermediaries provide direct assurances to investors concerning the behaviour of insiders and the accuracy of a firm's disclosure.[408] The entire system works on the premise that the financial cost of reputational loss for these intermediaries will exceed any gains obtained from cheating investors at any specific juncture, as explained more fully in Chapter IV.

B. Institutions and the fundamental problem of exchange

The main idea behind the analysis of formal and informal institutions is that they can deal with the *fundamental problem of exchange*.[409] The sequential nature of exchange creates the space for opportunism, which can deter individuals from dealing with each

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405 Without this punitive element, informal institutions would not have a visible effect on the behaviour of market participants. J Macey (2010). For a discussion of 'reputational penalties', see Chapter IV.

406 Norms are also a well-known example of an informal institution that can work as described above. The term 'norms' refers simply to 'informal rules of conduct that constrain self-interested behaviour but that are not enforced by any authoritative body'. The Oxford English Dictionary (OUP, Oxford 1989) contains the following definition: 'A standard or pattern of social behaviour that is accepted in or expected of a group'. For relevant discussions, see RC Ellickson, *Order Without Law: How Neighbors Settle Disputes* (Harvard University Press 1991) and MA Eisenberg, 'Corporate Law and Social Norms' (1999) 99 COLUM L REV 1253, 1292. See also Chapter V.

407 J Macey (2010). 'Reputations can be used to infer the otherwise unobservable quality of a firm'. See PM Lee and others (2011).

408 B Black (2001).

409 A Greif, The fundamental problem of exchange: A research agenda in historical institutional analysis, (2000) 4 Europ Rev Econ Hist 251-284.

other unless proper assurances are in place.[410] The fundamental problem of exchange can be overcome when institutions are available to reduce the payoffs of individuals that breach their commitments, which allows counterparties to commit credibly to deal fairly with each other in the future.[411]

This general function of institutions translates easily into the context of capital markets. In fact, the notion of adverse selection discussed in the previous section may be seen as a direct offshoot of the fundamental problem of exchange. Investments in a listed firm involve simply 'an exchange of a sum of money today for a promise to return more money in the future'.[412] The sequential nature of this exchange creates the space for the initial recipients of these funds (i.e. corporate insiders) to behave opportunistically towards investors. Investors that intend to acquire shares in a public exchange will therefore face an adverse selection problem when choosing between listed firms, since they do not know ex ante if they will receive a fair return for their investment.

The institutions studied in the following Chapters are meant to limit the payoffs to controlling shareholders that behave opportunistically. In line with the discussions laid out in Section 2 above, these limits should ensure that the costs that investors bear from private benefit extraction do not surpass the benefits they receive from the controller's activities.[413] In addition, institutions should reduce the payoffs that insiders gather from making incomplete disclosures, so as to ensure the public availability of accurate information about the firm's finances.

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410 A Greif, Coercion and exchange: How did markets evolve, (2008) 15.

411 A Greif (2008) 11.

412 L Guiso and others, The Role of Social Capital in Financial Development, (2001) 94 AMER ECON REV 3. 'Whether such an exchange will take place depends upon not only the legal enforceability of contracts, but also the extent the financier trusts the financee'. Id.

413 RJ Gilson and A Schwartz (2012).

When formal and informal institutions accomplish these goals, investors will have the credible assurances they require to overcome adverse selection. For this purpose, as explained in Chapter III, formal institutions may allow investors to exercise certain rights or to seek redress before external authorities. In this case, recourse to the legal system gives rise to the credible assurances required by outside investors. Informal institutions can perform a similar function, as they give rise to credible mutual expectations (i.e 'trust') between outside investors and insiders. In the examples described in Chapter IV, reputational intermediaries provide the requisite assurances and stake their reputational capital to back up their pledge to investors.

The degree to which formal and informal institutions can influence the behaviour of insiders depends on a variety of factors.[414] For instance, the fitness of the state apparatus may be an important determinant of the effectiveness of formal institutions in achieving this goal. Formal institutions are a central part of finance in modern industrialized nations, where the state can exercise a muscular influence over market participants, but may have played a less important role when capital markets initially developed in some of these jurisdictions.[415] Informal institutions are thought to be of some importance in countries in which the state is too weak to effectively regulate the behaviour of market participants.[416] This set of facts points to a close relation between the health of the state apparatus and the nature of a country's prevailing institutions: the

414 J Armour and others (2010a).

415 C Burhop, D Chambers and BR Cheffins (2011); C Mayer (2008).

416 JR Macey, The demise of the reputational model in capital markets: The problem of the 'last period parasites' (2010b) Yale Faculty Scholarship Series Paper No. 1388.

stronger the state, the larger the role of formal institutions as a means to control the actions of corporate insiders.[417]

Although this conclusion appears obvious—as formal institutions often derive their effectiveness from a state's bureaucracy—it does not capture the full complexity of the relation between institutions and the condition of the state in which they operate. In fact, certain types of formal institutions (i.e. self-enforcing rules, SRO regulation) may work better than others (i.e. judicial fairness reviews) against the backdrop of a weak state.[418] Moreover, informal institutions can remain central to the operation of stock markets even when the state is strong, as seen in the informal enforcement techniques deployed in the UK or the system of reputational intermediation that still operates across most industrialized nations.[419]

Nor is the strength of the state the only determinant of a country's institutional makeup. For instance, a deficient state apparatus does not automatically create the space for informal institutions to take over. A nation's industrial structure, share ownership patterns and cultural background may have an impact on the effectiveness of informal institutions in dealing with the problems analysed here.[420] Equally important is the fit between formal institutions and ownership structures. As explained below, certain types

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417 B Liebman and C Milhaupt (2008).

418 Although the application of self-enforcing rules depends on the actions of private parties (i.e. exercise of voting rights by shareholders), it is ultimately the state (or an official organization) that either designs these rules or backs up their enforcement. In fact, as explained in Chapter III, any controversies regarding the actual application of self-enforcing rules will be settled by the state or, in some cases, by parties that the state has authorized to deal with conflicts of this nature (i.e. SROs, arbitration panels).

419 JC Coffee, Gatekeepers: The Role of the Professions and Corporate Governance, Clarendon Lectures in Management Studies (OUP 2006); RJ Gilson and R Kraakman, The mechanisms of market efficiency, (1984) 70 VIRG L REV 4, 549-644. See also discussions in Chapter IV.

420 See Chapter V for a more elaborate description of these relations and the possible existence of feedback effects between a nation's macroeconomic features and its institutions.

of formal legal rules (i.e. those that mandate independent directors and special board committees) are in fact well suited to firms in which share dispersion shifts the centre of corporate power to the board of directors, while others (i.e. outside shareholder approval of conflicted transactions) may work best under ownership concentration.

These preliminary remarks suggest that there is a multi-layered relation between institutions and the context in which they operate. The nature of this relation may largely determine the ability of formal and informal institutions to influence the behaviour of insiders in listed firms and, accordingly, to deal with adverse selection in capital markets. As a first step toward understanding this complex relation, the following Chapter looks at some of the main formal institutions that are available to govern the activities of insiders in listed firms.

Chapter III

The formal institutions of capital markets

1. The legal system and the behaviour of insiders

As defined in the previous Chapter, formal institutions are the components of a system, vested with official authority, that explicitly regulates the behaviour of firms and individuals in capital markets. This definition includes both the laws enacted and enforced by the state, as well as the internal rules administered by self-regulatory organizations (SROs) amongst their members. This Chapter is mainly concerned with the ways in which legal measures can limit self-dealing by insiders in listed firms in order to achieve the goals described in Chapter II.[421]

Self-dealing is usually targeted directly through ex ante safeguards that make it hard for insiders to expropriate outside investors (i.e. bans, supermajority voting requirements, disclosure of conflicted transactions) or ex post remedies designed to punish tunnelling and allow investors to seek compensation for the loss of firm value (i.e. fairness reviews).[422] Self-dealing may also be addressed through indirect measures that seek to mitigate agency problems on a more general level, including restrictions on

[421] The goal of ensuring proper disclosure mentioned in Chapter II is not discussed in much detail here. This goal may be accomplished through mandatory rules that dictate the content and the frequency of corporate disclosures, with a matching threat of liability for non-compliance. For relevant discussions, see M Fox, Retaining mandatory securities disclosure: Why issuer choice is not investor empowerment, (1999) 85 VIRG L REV 7.

[422] A Dyck and L Zingales (2004); T Nenova, 'The Value of Corporate Votes and Control Benefits: A Cross-country Analysis (2003) 68 J FIN ECON 325, 351; MJ Barclay and CG Holderness, 'Private Benefits of Control of Public Corporations' (1989) 25 J FIN ECON 371, 395. Chapter II described the different techniques available for 'tunnelling' firm resources, the process through which insiders expropriate outside investors.

disproportional ownership structures (i.e. those that create a disparity between voting and cash flow rights) or mandatory requirements to appoint independent directors.

Legal measures (i.e. bans, rules, standards) are seen as the first line of defence against the expropriation of minority investors.[423] These measures are simply the formal embodiment of strategies that seek to limit self-dealing directly or that by otherwise mitigating agency costs have an indirect effect on this behaviour.[424] Significant efforts have been put to the task of sorting out the large number of existing measures into manageable categories that speak to the subtle differences in their nature.

A criterion that is commonly used to classify legal measures speaks to the degree of intervention by an external authority (i.e. regulators, judges) that is required to bring their desired effects to fruition. From this perspective, one could imagine a continuum that places self-enforcing rules at one end, as these measures require only minimal outside intervention. As explained in more detail below, these rules are not entirely 'self-enforcing', since the intervention of an external authority may be required to verify that they have been properly applied. At the other end of the continuum are measures that allow investors to hold insiders accountable for their actions (i.e. standards and procedures for judicial review), where the burden for effectiveness lies heavily with the

423 V Atanasov, B Black and C Ciccotello, Self-dealing by corporate insiders: Legal constraints and loopholes (2011), Northwestern University Law and Economics Research Paper No. 7.

424 For a review of these strategies, see J Armour, H Hansmann and R Kraakman, 'Agency Problems and Legal Strategies' in R Kraakman and others (eds), *The Anatomy of Corporate Law* (OUP, Oxford 2009) 35. The authors mention a variety of legal strategies, including the use of rules, standards, terms of entry and exit, provisions for the selection and removal of directors and managers, initiation and veto rights and trusteeship and reward policies that act on the incentives of agents. Aside from rules that seek to mitigate agency costs, properly enforced tax rules can also have a potentially large impact on the extraction of private benefits, as well as an effect on the structure of share ownership in listed firms. See SA Bank and BR Cheffins (2008).

actions of an external authority.[425] Somewhere in the middle of the continuum, closer to self-enforcing rules than to standards, one may find bans imposed on transactions tainted by a conflict of interest (i.e. insider trading or loans to corporate officers and shareholders), where state intervention may be required to verify that the factual hypothesis subject to proscription has arisen.

Another effort to classify legal measures in the context of corporate governance takes into account the way in which ownership structures affect the allocation of powers within a listed firm.[426] In firms with concentrated ownership, the power to preside over corporate affairs lies with controlling shareholders in their capacity as either managing insiders or outside monitors.[427] Conversely, ownership dispersion shifts the allocation of power towards directors and officers, with shareholders usually playing a residual role over the affairs of the corporation.[428] To the extent that these differences alter the constituency that is primarily targeted for regulation (i.e. controlling shareholders or directors and officers) they can have an impact on the content of legal measures.

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425 J Armour, H Hansmann and R Kraakman (2009); Z Goshen, The efficiency of controlling corporate self-dealing: Theory meets reality (2003) 91 CAL L REV 2, 399.

426 V Atanasov, A Boone and D Haushalter, ‘Is there shareholder expropriation in the US? An analysis of Publicly Traded Subsidiaries’ (2008) 45 J FIN QUANT ANAL 1, 26; J Armour, Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment’ ECGI Law Working Paper No. 106/2008; PH Conac, L Enriques and M Gelter, Constraining dominant shareholders’ self-dealing: The legal framework in France, Germany and Italy (2007) 4 EFCR 491, 528.

427 CG Holderness (2008) Majority shareholders are rarely outsiders concerned with preventing the diversionary activities of management; instead, available evidence supports the view that large shareholders tend to directly intervene in running the firm. (Id. See also T Nenova (2001)). To the extent that such individuals cannot be expected to supervise themselves, the traditional monitoring story relayed by corporate governance scholars is not an entirely accurate account of the role that blockholders play with regard to a firm’s internal governance in firms with concentrated ownership.

428 Another possible classification looks at the object of each strategy, namely, the specific type of tunnelling technique that is targeted. This classification takes into account the distinction between cash flow, asset and equity tunnelling described in Chapter II. See also V Atanasov, B Black and C Ciccotello (2011).

Aside from their heuristic value, these taxonomies offer a few clues as to how well legal measures match the specific setting in which they are deployed.[429] Consider, for instance, the different approaches available to deal with transactions between affiliated parties. At least in theory and subject to the caveats made in Chapter VI, self-enforcing rules that target the actions of majority shareholders (i.e. supermajority voting requirements, appraisal remedies) could be well suited to firms with concentrated ownership in countries where the state apparatus is weak, while a system of standards focused on the accountability of board members (i.e. fiduciary duties, fairness reviews) could work most effectively in firms with dispersed ownership operating in jurisdictions with a strong judiciary.[430]

This Chapter looks at legal measures with reference to their reliance on the intervention of an external authority. Even if there are other analytical criteria under which these measures could be examined, the one employed here is particularly relevant in the context of Latin American countries, where the influence of the state over corporate activity is tenuous at best. This exercise therefore serves as a first step to understand which types of legal measures may be best suited to control self-dealing in the region. The discussions below will suggest that reforms meant to improve the legal

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429 There are, however, important limits to the inferences one may draw here. Differences in regulatory style may lead to different institutional configurations across countries that share similar backgrounds. For instance, while self-enforcing rules and informal enforcement are important instruments to deal with agency problems in the UK, the US takes a different approach that focuses on higher levels of corporate litigation based on standards of conduct. J Armour (2008).

430 In the US, where ownership is dispersed in large listed firms, the rules against asset tunnelling rely on the approval of a specific transaction by non-interested directors alongside the standards set by fiduciary duties and, in some cases, judicial fairness reviews. See V Atanasov, B Black and C Ciccotello (2011). France and Italy, where there is a high degree of ownership concentration, also have a system of fiduciary duties for directors, but one that is supplemented by rules against the abuse of power by majority shareholders and in favour of the equal treatment of all shareholders. See PH Conac, L Enriques and M Gelter (2007).

safeguards against tunnelling require an intimate knowledge of local conditions, which in turn points to a seemingly obvious conclusion that has nonetheless been ignored by recent efforts for legal reform in Latin America: ‘there is no single efficient solution suitable for every country’.[431]

2. Legal measures and the intervention of external authorities

The effectiveness of legal measures against self-dealing relies on the action of external authorities. However, the degree to which such intervention is required may vary significantly depending on the nature of the legal measure. As explained earlier, self-enforcing rules require only minimal intervention on the part of external authorities. Self-enforcing rules can come in many forms, including procedural requirements whereby a conflicted transaction is subject to approval or ratification by disinterested directors and shareholders.[432] Another example of self-enforcing rules may be found in the provisions that grant specific rights to shareholders upon the execution of certain transactions, as in the case of appraisal remedies and pre-emptive rights.[433]

Procedural requirements and special shareholder rights are examples of self-enforcing rules that directly target tunnelling. There are also countless rules of a self-enforcing nature that seek to mitigate agency problems more generally and only obliquely constrain tunnelling. Some relevant examples include rules on the appointment and composition of the board of directors (i.e. cumulative voting, independent director requirements, board committees) and dividend distributions. Despite the self-enforcing

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[431] Z Goshen (2003).

[432] J Armour, H Hansmann and R Kraakman (2009); Z Goshen (2003); B Black and R Kraakman (1996).

[433] B Black and R Kraakman (1996).

nature of these legal rules, some intervention by external authorities is often unavoidable. For instance, a responsive external authority may be required to prevent fraudulent attempts to circumvent self-enforcing rules or to adjust these rules to changing corporate practices, as illustrated in the cases described further below.[434]

A similar situation arises in the context of legal measures that set out bans against certain actions. Examples of this kind of measure include the proscription of loans to insiders or bans on the issuance of nonvoting or multiple voting shares. In some cases (i.e. loans to insiders hiding behind offshore SPVs), the individuals seeking to enforce the ban may require an external authority to determine that the factual conditions regulated under the law actually arose. Moreover, certain bans (i.e. the one share, one vote rule) may not accomplish their stated objective (i.e. ensure that shareholders have an equal measure of voting and cash flow rights) if an external authority is not available to continuously fine-tune them in order to match evolving business practices (i.e. the use of pyramids instead of nonvoting shares to separate voting and cash flow rights).

Bans and self-enforcing rules do not place as high a toll on state resources as legal measures that allow investors to hold insiders accountable for their actions.[435] In the case of bans and self-enforcing rules, external authorities will mostly be concerned with the formal outlines of conflicted transactions and with gradual adjustments to the system of written rules. In contrast, holding corporate actors accountable requires substantive reviews concerning the inherent fairness of a transaction or the adherence of these

434 C Sunstein, The problem with rules, (1994) 4 CAL LAW REV 85,997. Also, 'any judgment whether to apply the rule to the particular case depends on a moral or political claim about relevant differences and relevant similarities between the acknowledged exception and the case at hand. Hence a degree of ex post judgment is inevitable'. Id. 985.

435 J Armour, H Hansmann and R Kraakman (2009).

insiders to standards of conduct. Generally, after a challenge by an aggrieved party, an external adjudicator will scrutinize the actions of corporate actors and, if she finds that a standard of conduct has been breached, the relevant transaction will be subject to review in order to assess its potential damage to the firm or related constituents.

Holding insiders accountable requires a system that combines legally defined standards, able adjudicators and procedural law. The first of these three components consists of formal laws and judicial doctrines that define the benchmark against which the conduct of insiders and the fairness of a transaction can be assessed. For instance, under current Delaware law—in its simplest expression—fiduciary duties included in the state's corporate code provide the relevant standard of conduct for corporate insiders. If a court finds that insiders have breached these duties, they will conduct a stringent review into the fairness of the contested transaction.[436] Over the years, Delaware rules have specialized in certain areas (i.e. takeovers, director-shareholder and majority-minority conflicts), mixed procedural requirements with substantive reviews (i.e. the 'Zapata two-step')[437] and incorporated novel standards (i.e the Unocal, Revlon, Time-Warner rules)[438] to such an extent that navigating through the complexities of the state's adjudication practices for conflicted transactions is no easy task.[439]

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436 Delaware's system of adjudication is, of course, infinitely more complex than what is described here. See V Atanasov, B Black and C Ciccotello (2011) 19; J Armour, JB Jacobs and C Milhaupt, A comparative analysis of takeover regimes in the US, UK and Japan (2010) Columbia Law and Economics Working Paper No. 377; RC Ferrara, KT Abikoff and LL Gansler, Shareholder derivative litigation: Besieging the board (Law Journal Press 2005).

437 Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981)

438 Unocal Corp. v Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Revlon Inc. v MacAndrews & Forbes Holdings Inc., 506 A.2d 173 (Del. 1986); Paramount Communications Inc. v Time Inc, 571 A.2d 1140 (Del. 1989).

439 Some scholars argue that the indeterminacy created by Delaware's General Corporation Law benefits firms incorporated in that State. Even if other States copy Delaware's corporate code, the story goes, the indeterminate character of Delaware's rules for corporations leaves ample space for

Although standards may look different outside of Delaware and the United States, they pursue similar objectives and—crucially—also exact a heavy toll on adjudicators. Aside from setting out duties for directors, many countries also allow aggrieved shareholders to challenge transactions under alternative standards such as unfair prejudice and the doctrine of majority abuse.[440] Adjudicators are supposed to use these benchmarks to scrutinize contested transactions, which usually involves a complex process of discovery and analysis. For instance, the doctrine of majority abuse, as applied in Italy and France, requires adjudicators to determine whether or not majority shareholders made use of their voting rights 'to pursue their own self-interest (and not the company's) to the detriment of fellow shareholders'.[441] This task presupposes a detailed review of the background, financial terms and procedural aspects of a specific transaction and forces adjudicators to probe into the motives of majority shareholders, often by taking into account nothing more than circumstantial evidence.

The difficult task of measuring the behaviour of insiders against standards of conduct leads to the second essential component of any system that relies on ex post reviews. For a system of this nature to work, able adjudicators must be at hand to unravel

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the State's judiciary to give content to the law through its rulings in specific cases. 'By being judge-oriented, Delaware corporate law becomes a proprietary product of Delaware, one that other states find difficult to match'. E Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, (1998) 98 COL L REV 1908.

440 On unfair prejudice, see P Davies, *Introduction to Company Law* (OUP, Oxford 2002). On equal treatment and majority abuse, see PH Conac, L Enriques and M Gelter (2007). On Canada's version of a related standard, see B Cheffins, The oppression remedy in corporate law: The Canadian experience (1988) 10 UNIV PEN J INT BUS L 3. For a description of how the majority abuse doctrine has been introduced for unlisted firms in Latin America, see F Reyes, Modernizing Latin American corporate law: Creating an all-purpose vehicle for closely-held business entities (2011) 29 P S INT L REV 2.

441 PH Conac, L Enriques and M Gelter (2007) 501. See also D Vidal, Droit des Sociétés (Fifth ed., LGDJ 2006).

the complexities of corporate action.[442] This calls for a large enough pool of independent adjudicators with technical expertise in corporate and financial matters, a feature that is uncommon even among developed countries.

The requisite qualifications for good corporate judges include not only independence and expertise, but also a laundry list of additional traits such as the ability to rise above formalism when necessary and a concern for 'the impact of their decisions on the future behaviour of corporate actors in general'.[443] Moreover, in the opinion of some authors, the expertise required to correctly evaluate corporate transactions presupposes the following elements: '(i) expertise in interpreting contractual language; (ii) expertise in evaluating evidence, especially trial evidence; (iii) expertise in inferring ex ante intended performances from actually rendered performances; and (iv) experience with the industry and with the types of transactions that come before the court'.[444]

The third necessary component of a system of ex post reviews concerns the procedural rules that must be in place in order for aggrieved parties to bring challenges against corporate actors. Rules that enable the aggregation of complaints (i.e. class actions) or that assign to the state the costs of bringing complaints (i.e. public enforcement) can facilitate the process of challenging the actions of insiders.[445] In addition, as explained further below, the rules that govern the apportionment of litigation

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[442] To this effect, 'a regime where the courts are inaccessible should be regarded as a system of nonintervention'. Z Goshen (2003).

[443] L Enriques, Off the books but on the record: Evidence from Italy on the relevance of judges to the quality of corporate law in *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals* (C Milhaupt, ed, Columbia University Press, New York 2003).

[444] RJ Gilson and A Schwartz (2012) 30-31.

[445] For a description of how public enforcement can act as a constraint on the behaviour of insiders, see HE Jackson and MJ Roe (2009).

expenses can supply incentives for investors to bring suits against perceived misbehaviour. Proper discovery proceedings and other rules concerning the collection and submission of evidence can also facilitate shareholder suits.

Procedural provisions such as the ones mentioned above often have a direct impact on the ability of outside investors to hold insiders accountable for their actions. The procedural rules that underpin the US system of corporate litigation, for instance, are considered to be one of the reasons for the high levels of enforcement intensity observed in this country.[446] Class actions and derivative suits against corporate insiders are in fact frequent in the US, both at the state and federal levels.[447] The so-called American Rule, under which litigants bear their own expenses, added to the fact that in many cases courts will order firms to cover the costs of investor plaintiffs, favours the active litigation of corporate misbehaviour.[448]

This situation stands in contrast to most European jurisdictions, where procedural obstacles are said to create an adverse environment for shareholder litigation through class actions and derivative suits.[449] An example of the negative impact that procedural rules may have on litigation involves the use of the *loser pays* rule for the apportionment of litigation expenses, a practice that is common across both industrialized and emerging markets. Under a rule of this nature, unsuccessful plaintiffs must bear the brunt of their

446 JC Coffee (2007).

447 See J Armour, B Black and BR Cheffins, Delaware's Balancing Act, Oxford Legal Studies Research Paper No. 64, 2010.

448 JD Cox and RS Thomas, Common challenges facing shareholder suits in Europe and the United States (2009) 2 ECFR 3, 354.

449 Despite the shortcomings of procedural rules for 'traditional' corporate litigation (i.e. derivative suits and class actions) in these European countries, investors may have alternative procedural means to challenge insider misbehaviour, such as the nullification of shareholder resolutions (France and Italy) and criminal proceedings against corporate insiders (France). PH Conac, L Enriques and M Gelter (2007).

own litigation costs as well as those of the defendant, which creates a powerful disincentive for outside investors to seek judicial redress against insiders.[450]

It has been argued that the use of a loser pays rule to apportion litigation expenses in the UK was one of several factors that explain the lack of derivative litigation in this jurisdiction.[451] Even though the UK allows the shareholders involved in derivative litigation to request an indemnity for costs from the company, there are still procedural hurdles that may deter investors from seeking to hold insiders accountable for unfair dealings.[452] The application of a loser pays rule is also considered to be an important deterrent to the initiation of derivative suits in many other European countries, where shareholder suits are scarce.[453]

3. The choice between different types of legal measures

Policymakers usually rely on a combination of different types of legal measures to govern the activities of listed firms.[454] For example, most Latin American countries ban loans to shareholders or the use of firm assets as collateral for the benefit of third parties.[455] At the

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450 J Armour (2008).

451 Id.

452 'Any such entitlement would not be established before the initial application to the court for permission to commence a derivative action. Hence the claimant shareholder would still bear a significant risk relating to the costs of the preliminary hearing'. Id.

453 In Italy, for instance, 'the derivative action and the class action exist on paper, in two statutes: the former is totally ineffective as will be to all extent and purposes the latter when it does come into effect (if ever)'. P Giudici, Representative litigation in Italian capital markets: Italian derivative suits and (if ever) securities class actions (2009) 2 ECFR 3, 269. See also B Black and others, Report to the Russian Center for Capital Market Development: Comparative analysis on legal regulation of the liability of members of the management organs of companies (2006).

454 J Armour, H Hansmann and R Kraakman (2009)

455 F Reyes (2008). Most Latin American jurisdictions have also committed to the principle of one share-one vote, enforced through the use of bans that proscribe non-voting or multiple voting shares. See JM Mendoza (2012).

same time, self-enforcing rules are used for conflicted transactions over firm assets, which must clear a procedural hurdle that grants veto rights to non-conflicted parties. Codified fiduciary duties for directors and a matching system of derivative litigation are available—at least on paper—to deal with most other types of conflicts of interest.[456]

The choice between different types of legal measures entails important trade-offs that should ideally inform the decisions of policymakers. To illustrate this point, the following discussion briefly considers the trade-offs between different legal measures in the context of the discretion granted to corporate actors, the cost that each type of measure imposes on policymakers and, finally, the practical application of legal measures in different contexts.

From an efficiency perspective, bans or self-enforcing rules may hinder the discretion of insiders to pursue legitimate corporate goals. This is due to the nature of these types of measures, which usually do not account for the particular conditions of a transaction and rely only on the objective criterion of whether or not there is a conflict of interest.

Consider, for instance, a self-enforcing rule that grants minority shareholders a veto right over related party transactions.[457] One problem with this rule is that not every conflicted transaction is inefficient or detrimental to the interests of the firm and outside investors.[458] This is particularly true in the context of business groups, where frequent

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[456] F Reyes (2008).

[457] Z Goshen (2003).

[458] A Pacces (2011).

transactions between affiliated firms can have synergistic advantages.[459] More importantly, as explained in Chapter VI, the 'internal markets' generated by tight relations between firms affiliated to these groups can substitute for shortcomings common to developing countries such as insufficient sources of finance, deficiencies in labour markets or poor contractual enforcement.[460]

A self-enforcing rule that bestows on minority investors the right to indiscriminately veto related party transactions has the potential to disrupt the normal operation of a business group and do away with the advantages tied to these types of organization.[461] At least in the context of business groups in developing countries, a rule of this nature would not be entirely compatible with the goal, stated in Chapter II, of ensuring that the costs that investors bear from private benefit extraction do not surpass the benefits they receive from the controller's activities. This analysis is revisited in Chapter VI, in the context of Latin American *grupos* and standalone firms.

Judicial reviews based on standards may be more versatile than bans or self-enforcing rules, depending, of course, on the abilities of the adjudicator. As described earlier, a system of judicial reviews allows conflicted transactions to go forward subject only to on-demand ex post scrutiny by an external authority. A system of this nature recognizes that not every conflicted transaction is necessarily inefficient.[462] To this effect, ex post reviews can filter out transactions that should be reversed or for which insiders

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459 T Khanna and Y Yafeh, 'Business Groups in Emerging Markets: Paragons or Parasites?' (2007) 45 JEL 331, 372; H Almeida and D Wolfenzon, 'A Theory of Pyramidal Ownership and Family Business Groups' (2006) 61 J FINANCE 2637, 2681.

460 See Chapter VI.

461 See L Enriques and others, 'Related-Party Transactions' in R Kraakman and others (2009). See also Z Goshen (2003) for an analysis of strategic interactions between insiders and outsiders in the context of 'majority-of-the-minority' rules.

462 RJ Gilson and A Schwartz (2012) 18; Z Goshen (2003).

could be held liable. If the external authority is sufficiently qualified to distinguish between different types of contested transaction and solve existing disputes in a reasonable amount of time, this system will grant insiders the latitude to conduct corporate affairs as they see fit while simultaneously giving minority investors the ability to challenge unfair transactions.[463]

From an efficiency perspective, however, a system of ex post reviews also generates a degree of uncertainty concerning the legality of insider actions. Whereas compliance with procedural requirements to clear a conflicted transaction (i.e. majority-of the-minority-approval) will generally insulate the transaction from further scrutiny, the application of standards carries with it the costly possibility of an unfavourable ex post review.[464]

Another relevant factor concerns the costs that policymakers must bear to design and fine-tune each kind of measure in order to effectively limit investor expropriation.[465] Although the introduction of legal measures against tunnelling will always require policymakers to expend some amount of effort, the costs of this activity may vary depending on the type of measure that is used.[466] For instance, bans usually involve high costs, as legislators are required to foresee as many future eventualities as possible in order to avoid creating loopholes. This may entail the drafting of detailed legislation that

[463] Some European jurisdictions use this approach to deal with related party transactions within corporate groups. See L Enriques and others (2009). However, as explained more thoroughly in Chapter VI, this approach may not be very effective in Latin American countries due to the scarcity of adjudicators able to judge the nature of the transactions carried out between group firms, an analysis that is bound to involve a high degree of complexity.

[464] C Sunstein (1994) 973; L Kaplow, Rules versus standards: An economic analysis (1992) 42 DUKE L J 3, 621.

[465] L Kaplow (1992).

[466] L Kaplow (1992).

catalogues the full list of behaviours targeted for proscription.[467] Self-enforcing rules may in some cases be less costly than bans, but will still require policymakers to anticipate the different situations in which a rule of this nature will be applicable.[468] From the perspective of legislators, a system of judicial reviews may be the least costly of all as it leaves ample space for ex-post adjudicators to determine the exact nature of the actions that should be censured and the scope of the sanction that must be imposed.[469]

Finally, there are important functional concerns that must be brought to bear in this discussion. Despite the advantages of ex post judicial reviews, the complex system that supports their operation is beyond the reach of most emerging countries. It is not easy for a single jurisdiction to combine the three elements that provide the foundations for a system of this nature: properly defined standards, able adjudicators and procedural laws that facilitate corporate litigation.[470] The UK experience with derivative suits provides a telling example of these difficulties.

For more than 150 years, the Common Law rules that governed derivative suits, laid out in the seminal case of *Foss v Harbottle* and its progeny, limited the ability of

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467 However, these high costs could be offset if a regulated behaviour is expected to take place frequently, as 'the added cost from having resolved the issue on a wholesale basis at the promulgation stage will be outweighed by the benefit of having avoided additional costs repeatedly incurred in giving content to a standard on a retail basis'. This same rationale leads one to conclude that regulating activities that only take place sporadically may be cheaper through the use of self-enforcing rules or rules that hold insiders accountable. C Sunstein (1994) 992.

468 L Kaplow (1992) 563.

469 Id. Nevertheless, one could also argue that the costs of supporting the judicial infrastructure required for ex post reviews outweigh the costs of enacting and fine-tuning bans and self-enforcing rules. Policymakers would therefore do well to weigh the costs of each type of legal measure with reference to the frequency of the regulated activity and the overall costs of the infrastructure required to make it work.

470 Enforcement by public agencies can replace private litigation as a means to hold insiders accountable for their misdeeds. One example of this may be found in Australia, a country with high levels of public enforcement channelled through the Australian Securities and Investment Commission, which can start civil, criminal and administrative proceedings against corporate insiders. JC Coffee (2007).

individual shareholders to bring litigation against directors.[471] Among the many obstacles faced by potential claimants, one could find the need to prove that wrongdoers held voting control, a requirement that became harder to meet as ownership dispersed in the UK, or, in cases of negligence, to show that wrongdoers benefited directly from their dereliction.[472] These obstacles had a visible effect on the use of derivative suits against directors in the UK: between 1990 and 2006, there were no reported judgments on litigation of this nature.[473]

To remedy this situation, Part 11 of the Companies Act 2006 introduced a new statutory procedure to govern derivative litigation under which courts employ a two-stage process to ascertain whether or not a shareholder will be granted permission to sue directors for breach of duty.[474] Even though these rules solved many of the problems associated with the old system, some obstacles still remain, including the significant discretion granted to courts to determine the admissibility of a complaint—courts in the UK have a long record of aversion to this sort of legal dispute—and the financial disincentives tied to litigation expenses discussed earlier.[475]

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471 (1843) 2 Hare 461, 67 ER 89. For an explanation of this case, see PL Davies, Gower and Davies' Principles of modern company law, (8th ed., Sweet and Maxwell, 2008). See also J Armour (2008).

472 A Reisberg, 'Derivative claims under the Companies Act 2006: Much ado about nothing?' in Rationality in company law: Essays in Honour of DD Prentice (J Armour and J Payne (eds), Hart Publishing, 2009). See also Law Commission (1996) Consultation Paper No. 142, available at http://www.justice.gov.uk/lawcommission/docs/cp142_Shareholder_Remedies_Consultation.pdf

473 J Armour (2008).

474 PL Davies (2008); A Keay and J Loughrey, Something old, something new, something borrowed: An analysis of the new derivative action under the Companies Act 2006, (2008) 124 LAW QUART REV 469.

475 A Reisberg (2008); J Armour (2008).

Early evidence suggests that derivative litigation has not yet taken off in the UK.[476] Although the UK has many other ways of dealing with insider misbehaviour—one could even argue that a policy choice has been made in favour of low litigation levels—the path followed by derivative suits in this jurisdiction illustrates how difficult it is to administer a system of ex post reviews that allows investors to hold insiders accountable for their actions.

In emerging countries, perhaps the main obstacle to set in motion a system of ex post reviews is the scarcity of adjudicators learned in corporate and financial matters. As discussed earlier, fiduciary duties and fairness rules require the intervention of able adjudicators that must apply these standards to complex and evolving business practices.[477] This task is mostly beyond the abilities of courts in developing jurisdictions, more adept at handling executive collection proceedings than corporate disputes.[478] Investors that seek judicial redress against self-dealing insiders in emerging countries will most likely be unsuccessful in their efforts, particularly if the dispute involves transactions of some complexity.[479]

It follows that, from a purely functional perspective, bans and self-enforcing rules seem better suited for emerging nations than a system of ex post reviews. This observation is reinforced by the fact that setting up the infrastructure required to sustain a

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476 See, for instance, Stimpson & Ors v Southern Landlords Association [2009] EWHC 2072 (Ch); Iesini v Westrip Holdings Ltd [2009] EWHC 2526 (Ch) and Franbar Holdings Ltd v Patel and ors [2008] EWHC 1534 (Ch).

477 'Developed economies usually have sophisticated enforcement institutions that can implement complex, finely nuanced rules. Emerging economies have less sophisticated enforcement institutions, and hence need simpler, more easily administrable rules'. B Black and R Kraakman, (1996).

478 K Pistor and C Xu (2003).

479 This adverse environment adds to the already exorbitant costs of private litigation in these jurisdictions, which makes litigation even less attractive for minority investors. Data on litigation costs in these jurisdictions is available at www.doingbusiness.org.

system of this nature is at best a long-term prospect. Policymakers in these jurisdictions may therefore be inclined to employ bans and self-enforcing rules to govern the behaviour of insiders in listed firms. Nevertheless, this approach also has some problems that merit attention, some of which are analysed below.

4. A self-enforcing model of corporate law?

One of the most ambitious experiments in business law design of recent times involved an attempt to set in motion what has been called a 'self-enforcing model of corporate law'.[480] Amid the turmoil that followed the collapse of the Soviet Union, Russia enacted the Law on Joint-Stock Companies of 1995. This statute was designed to operate in tandem with a mass privatisation program and against the backdrop of a weak state, where there were few constraints on the behaviour of corporate insiders.[481]

To accommodate for the feebleness of Russia's governmental infrastructure and the dubious business practices of the time, the architects of the 1995 Act focused their efforts on five key features: (i) reduce the intervention of outside adjudicators and other external participants by empowering shareholders, directors and managers; (ii) increase the protection of minority investors to a higher degree than in developed countries; (iii) focus on procedural approvals by non-conflicted shareholders and independent board members instead of bans; (iv) rely on bright-line rules instead of standards and (v) set out 'strong legal remedies *on paper*, to compensate for the low probability that the sanctions will be applied *in fact*'.[482] Following this blueprint, most of the self-enforcing rules

[480] B Black and R Kraakman (1996).

[481] V Frants, Is self-enforcement still the way to go? (2008) 13 UCLA J INT L & F AFF 435.

[482] B Black and R Kraakman (1996) 1916 (emphasis in the original).

discussed earlier were set in place, including independent director review and majority-of-the-minority approval for conflicted transactions, pre-emptive and appraisal rights, and cumulative voting for corporate elections.[483]

A short time after the enactment of the Law on Joint-Stock Companies, the promoters of the self-enforcing model acknowledged that the reform had failed to accomplish its stated goals.[484] This failure was tied to a number of problems now commonly associated with mass privatisation programs in transition economies.[485] Flawed privatisation policies, governmental corruption, shady business practices and the lack of a solid infrastructure to prevent fraud contributed to the failure of the self-enforcing model in Russia.[486]

These context-specific problems mean that Russia's experience with a self-enforcing system is not immediately relevant for other emerging countries, particularly if these did not form part of the transition away from centralized economic planning after the fall of the Soviet Union. However, the failure of the Russian Law on Joint-Stock Companies does offer some clues about the limits of self-enforcing rules. Even under conditions much less extreme than the ones present in Russia during the 1990's, the use of self-enforcing rules still poses a serious regulatory problem.[487]

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483 V Frants (2008); B Black, R Kraakman and A Tarassova, Russian privatization and corporate governance: What went wrong? (2000) 52 STAN LAW REV 6, 1731-1808.

484 B Black, R Kraakman and A Tarassova (2000).

485 See MB Fox and MA Heller (eds), Corporate governance lessons from transition economy reforms (Princeton University Press: 2007)

486 B Black, R Kraakman and A Tarassova (2000). The authors' list of ails is much more extensive and includes, 'a punitive tax system […], organized crime, an unfriendly bureaucracy, and a business culture in which skirting the law is seen as normal, even necessary behaviour'. (id. At 1735).

487 See C Sunstein (1994) for a thorough analysis of the deficiencies usually associated with systems of rules (as opposed to standards).

Across developing countries, the combination of highly concentrated ownership and low enforcement intensity in corporate and commercial matters gives insiders a free hand to conduct the firm's affairs.[488] This creates ample space for them to work around self-enforcing rules.[489] To this effect, 'similar to tax planning, if there are several ways to a given goal, and the law only blocks some of them, tunnellers can often follow the path less-regulated'.[490] The available evidence in fact suggests that self-enforcing rules designed to constrain the expropriation of outside investors are circumvented with ease in emerging countries.[491]

It is a well-known fact, however, that insiders find a way around systems of rules even in the most developed jurisdictions.[492] The high costs of wholesale regulation, along with limited cognitive resources, make it impossible for policymakers to anticipate every possible contingency ex ante.[493] Nevertheless, any flaws observed in the system elicit—at least ideally—an official response that seeks to close loopholes and punish deliberate attempts to circumvent existing rules.[494]

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488 For instance, in the context of lending relationships it has been suggested that 'abusive strategies are easier to implement when ownership is concentrated and managers are tightly controlled by owners'. G Akerlof and others, Looting: The Economic Underworld of Bankruptcy for Profit, (1993) 2 BROOKINGS P ECON ACT 7.

489 C Sunstein (1994) 997.

490 V Atanasov, B Black and C Ciccotello (2011) 12.

491 B Black and others (2006).

492 V Atanasov, B Black and C Ciccotello (2011) 12.

493 C Sunstein (1994) 992.

494 Regulatory responses to the detection of flaws in a system of rules often involve a gradual process of improvement and fine-tuning. However, large-scale responses also happen with some frequency, mostly after large corporate scandals or in the wake of a financial crisis. See S Banner, What causes new securities regulation: 300 hundred years of evidence, (1997) 75 WASH UNIV LAW Q 849. See also JC Coffee, The political economy of Dodd-Frank: Why financial reform tends to be frustrated and systemic risk perpetuated (2012) Columbia Law and Economics Working Paper No. 144.

In emerging countries, policymakers are much less responsive when it comes to addressing the flaws that ail a system of rules.[495] This may be due in part to financial and human capital constraints that slow down the response time of regulators and lawmakers. Interest groups of all sorts—corporate conglomerates, lawyers, accountants, notary publics, chambers of commerce—that seek to protect the rents they derive from the preservation of the *status quo* can also slow down official responses to imperfections in the legal rules that target corporate misbehaviour.[496]

The lack of an ongoing process to review how self-enforcing rules are being applied in practice gives ground to insiders that intend to circumvent the mechanisms designed to protect outside investors.[497] Some examples can perhaps illustrate this point.

Consider first the election of independent directors as a means to attenuate the influence of controlling shareholders over the board.[498] The independence of prospective candidates to the board is usually assessed with reference to a ready-made checklist

495 MJ Roe and JI Siegel, 'Political Instability: Its Effects on Financial Development, its Roots in the Severity of Economic Inequality' Working Paper 2009 http://ssrn.com/abstract=963214; A Chong and F López de Silanes, 'Corporate Governance in Latin America' (2007) Inter-American Development Bank Working Paper No. 591.

496 LA Bebchuk and Z Neeman, 'Investor Protection and Interest Group Politics' (2010) 23 REV FINANC STUD 1089, 1119.

497 Some authors have pointed out that, absent this process of constant adjustment, mandatory rules (whether self-enforcing or not) may more often 'codify loopholes and create pointless rigidities' than actually constrain the diversionary behaviour of controlling shareholders. J Armour, H Hansmann and R Kraakman (2009) 40. The authors' assertion is equally true of rules voluntarily adopted by shareholders, which also require a degree of state intervention to function properly.

498 There is mixed evidence concerning the impact that independent directors, a staple of corporate governance codes around the world, can have in listed firms on both developed and developing countries. For a discussion of the available evidence, see L Bebchuk and A Hamdani, The Elusive Quest for Corporate Governance Standards, (2009) John M. Olin Discussion Paper No. 633. For specific studies on the developed world, see DA DeMott, Guests at the table?: Independent directors in family-influenced public companies (2008) 33 J CORP L 4, 819-863; J Dahya, O Dimitrov and JJ McConnell, Does board independence matter in companies with a controlling shareholder? (2009) 21 J APP CORP FIN 1, 67-78. For a study of emerging countries, see See B Black and others, What Matter and for Which Firms for Corporate Governance in Emerging Markets? Evidence from Brazil (and other BRIK Countries) (2012) J CORP FIN (this study found a negative relation between board independence and firm value in Brazil, a positive impact in Korea and no effect in India).

included in the bylaws or in codes of good practice, without any real scrutiny by adjudicators or third parties.[499] Disguised by this box-ticking exercise, insiders are usually free to appoint directors who are only ostensibly independent.[500]

Even if independent directors were to be procured, controlling shareholders would still exert a dominant influence on the board and retain the ability to dismiss troublesome directors. Independent board members that do not yield to the interests of controlling parties can therefore be replaced with other independent directors that are more accommodating to the needs of insiders. This problem is thought to be recurrent in some developing countries.[501]

Self-enforcing rules that grant outside shareholders the right to approve conflicted transactions are equally problematic, as these rules also rely on the constant intervention of external authorities. Before these safeguards can come into play, policymakers must carefully outline which transactions will be subject to approval or ratification, and name the actors that will be granted the power to review them. After these issues have been dealt with, outside intervention will be required to adjudicate any controversies concerning the actual application of the procedural requirements. Many issues can come

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499 It is also relevant to note that cumulative voting systems that grant outside investors the ability to elect a few directors can lead to adversarial boards in which meetings are scarce and crucial facts about the firm's activities are either withheld from 'minority' directors or hidden under floods of irrelevant data. See F Reyes (2008) and S Bainbridge, Corporation Law and Economics (Foundation Press, 2002), 445-446.

500 See L Bebchuk and A Hamdani (2009) for a discussion on how to assess director independence in firms with a controlling shareholder.

501 MW Peng, Outside Directors and Firm Performance During Institutional Transitions (2004) 25 STRAT MAN J 453. In South Korea, where most listed firms are under the control of corporate groups known as *chaebols*, it was a common occurrence for the actions of independent directors to be influenced by controlling shareholders. 'Even a director unaffiliated with management will likely listen to the control shareholders. Otherwise, the director will displease those with the power to reappoint her to her next term'. M Fox, Reforming derivative suits in Korea: A comment on Professor Song (2004). See also CH Song and BT Kim, Taking shape in Korea (2010) IFLR Corporate Governance Supplement.

up at this stage, including whether or not the transaction was subject to ex ante consent or if the formalities for approval or ratification were actually observed.[502]

Most importantly, external authorities play a central role in making sure that these self-enforcing rules match corporate practice on an ongoing basis.[503] If, for instance, the law requires outside shareholder approval for the sale of firm assets to majority shareholders, the latter will rationally shift to cash tunnelling techniques or, in extreme cases, insiders may try to conceal their control over the purchasing party through offshore special purpose vehicles.[504] It is at this point that the intervention of external authorities becomes essential, whether to include cash tunnelling in the laundry list of transactions subject to approval or to disentangle complex corporate structures.

On a related note, bans also require a degree of intervention by external authorities to function properly. Perhaps the best example here is the use of bans to enforce the principle of one share, one vote. When entrepreneurs detach voting power from cash flow rights in a listed firm—through, for instance, the issuance of non-voting shares to outside investors—the agency problem between controlling and minority shareholders can reach its most acute form.[505]

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502 In the case of appraisal remedies, preemptive rights and mandatory bids there might also be some controversy as to the actual value of the shares in dispute, which would require professional independent experts to be called upon to address this issue.

503 V Atanasov, B Black and C Ciccotello (2011) 12.

504 A similar problem exists in the context of money laundering activities. See E van der Does de Willebois and others, The Puppet Masters: How the Corrupt Use Legal Structures to Hide Stolen Assets and What to Do About it, (2011) World Bank: Stolen Asset Recovery Initiative.

505 For a discussion of this practice in the context of Latin America, see JM Mendoza, 'The Challenge of Disproportional Ownership' in *Readings in Latin American Company Law* (North Carolina University Press 2012). For a similar analysis in Europe, see A Kalay and S Pant, One Share-One Vote is Unenforceable and Sub-optimal, Working Paper 2009 http://ssrn.com/abstract=1558449; G Psarakis, One Share-One Vote and the Case for A Harmonised Capital Structure (2008) 19 EUR BUSINESS L REV 733; G Ferrarini, One Share-One Vote: A European Rule? (2006) 3 ECFR 146, 177.

In the extreme case a of *controlling minority shareholder*, an individual who holds the majority of a firm's outstanding voting rights is entitled only to a minority share of its cash flows.[506] These controlling minority shareholders are placed in a sort of middle ground between dispersed and concentrated ownership.[507] As majority shareholders, they are immune to control contests. However, these individuals do not bear a majority share of the wealth effects generated by their decisions (due, of course, to their minority cash flow stakes).[508] This brings their incentive structure close to that of managers in widely held firms.[509] In their capacity as entrenched insiders with significant incentives to extract private benefits, controlling minority shareholders are highly likely to engage in acts that harm outside investors.

A ban based on the principle of one share, one vote is therefore meant to prevent extreme misalignments between the interests of insiders and outside investors.[510] To accomplish this goal, listed firms are directed to only issue shares that grant their holders an equal measure of voting and cash flow rights. Multiple voting shares, non-voting preferred shares and similar specimens would fall under the scope of the prohibition. Nevertheless, insiders have innumerable other ways of separating voting and cash flow

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506 LA Bebchuk, R Kraakman and G Triantis, 'Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights' in R Morck (ed) *Concentrated Corporate Ownership* (University of Chicago Press 2000) 295, 318; R Morck, D Wolfenzon and B Yeung 'Corporate Governance, Economic Entrenchment and Growth' (2005) 43 J ECON LIT 655, 720.

507 K Geens and C Clottens, 'One Share–One Vote: Fairness, Efficiency and (the Case for) EU Harmonization Revisited' in K Hopt and K Geens (eds) *The European Company Law Action Plan Revisited: Reassessment of the 2003 priorities of the European Commission* (Leuven University Press 2010).

508 TY Yen and P André, 'Ownership Structure and Operating Performance of Acquiring Firms: The Case of English-origin Countries' (2007) 59 J ECON BUS 382.

509 EF Fama and MC Jensen 'Separation of Ownership and Control' (1983) 26 J LAW ECON 301, 325.

510 G Psarakis (2008) and G Ferrarini (2006).

rights in listed firms, including pyramidal structures, cross-holdings, derivative products and shareholder coalitions.[511]

Without an external agent that can determine whether or not these alternative schemes are being used to separate voting from cash flow rights, the bans designed to promote the one share, one vote principle will have few practical effects.[512]An interesting example comes from the Novo Mercado in Brazil, where anecdotal evidence suggests that the introduction of a ban on non-voting shares has stimulated the use of pyramidal structures.[513] Another example may be found in Italy, where successive attempts to introduce a one share, one vote rule were invariably followed by the use of novel mechanisms to circumvent it.[514]

It must be noted that even if a one share, one vote rule were enforceable, it would almost completely disregard the multiple benefits tied to the separation of voting and cash flow rights.[515] The introduction of an enforceable one share, one vote rule might still be efficient if the gains for outside investors were higher than the loss of value for corporate insiders. Nevertheless, theoretical models and empirical evidence suggest that this would not be the case.[516] To paraphrase a study on the subject, bans based on the one share, one vote principle are unenforceable and sub-optimal.[517]

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511 A Kalay and S Pant (2009); OECD, 'Lack of Proportionality between Ownership and Control' (2007) http://www.oecd.org.

512 A Kalay and S Pant (2009).

513 See Chapter VI.

514 M Bianco and M Bianchi, Italian corporate governance in the last 15 years: From pyramids to coalitions (2006) ECGI Finance Working Paper No. 144.

515 JM Mendoza (2012); G Ferrarini (2006) 174; K Rydqvist (1992) 55.

516 For a survey of the evidence, see M Burkart and S Lee, One Share-One Vote: The Theory, (2008) 12 ROF 1 and R Adams and D Ferreira, One Share – One Vote: The Empirical Evidence, (2008) 12 ROF 51.

517 A Kalay and S Pant (2009).

Chapter IV

The informal institutions of capital markets

1. The importance of informal institutions

Formal institutions undoubtedly have a hand in influencing the behaviour of corporate insiders in developed countries. As discussed in Chapter II, this fact has led policymakers to assume that improvements to the formal framework of legal investor protection will necessarily promote stock market development in emerging countries. There are at least two problems with this approach.

The first problem was explained in the previous Chapter. To sum it up, legal rules—even those of a self-enforcing nature—require a solid underlying infrastructure to function properly. The experience of policymakers across Latin America and elsewhere suggests that emerging countries may not always meet this requirement.[518]

The second problem is that policymakers may be placing too much emphasis on the significance of formal institutions for capital market growth. At least by historical standards, a legal system in working order does not appear to be essential during the initial stages of financial development.[519] Stock markets in Germany, Japan, the UK and the US in fact grew at a significant pace well before enforceable legal rules came into play.[520] In all of these jurisdictions, alternative mechanisms that operated independently

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518 There are numerous ways of improving the state infrastructure that supports rules in order to enhance the effects of legal reform. Most of the available options (i.e. judicial reform) are long-term prospects that can only be pursued at significant cost. However, unorthodox institutional arrangements may provide shortcuts towards this goal. See Chapter VI for a detailed explanation of institutional reform along these lines.

519 C Burhop, D Chambers and BR Cheffins (2011).

520 F Allen and others (2010): BR Cheffins (2008).

of the state supported market exchange. Although these mechanisms were varied in nature, they all shared one central feature in their ability to generate and sustain informal relations of ‘trust’. It was this element that provided the support for stock markets to take off even in the absence of strong formal institutions.[521]

Whilst academics and policymakers have traditionally focused on how legal rules mitigate adverse selection in stock markets, the study of informal relations of ‘trust’ in this context has received less attention.[522] To be sure, the main developments concerning these informal relations have taken place in other settings. Following Avner Greif’s pioneering work on how reputation facilitated exchange within a coalition of medieval Maghribi traders,[523] the field has expanded to cover backgrounds as diverse as those of cattle ranchers in California,[524] orthodox Jewish diamond merchants in Brooklyn[525] and Julfan Armenian trade networks in the Middle East.[526]

This Chapter explores the ways in which the mechanisms that sustain informal relations of ‘trust’—informal institutions—can deal with adverse selection in stock markets. Drawing from the available literature on the historical importance of informal institutions in industrialized countries, the discussions below develop a theoretical

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521 C Mayer (2008).

522 ‘Informal relations of trust are as important in financial development as more formal arrangements and to date inadequate attention has been devoted to them in comparison with their more formal regulatory counterparts’. C Mayer (2008) 618.

523 A Grief, Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders (1989) 44 J ECON HIST 4, 857-882.

524 RC Ellickson, Order Without Law: How Neighbors Settle Disputes (Harvard University Press 1991).

525 L Bernstein, Opting out of the legal system: Extralegal contractual relations in the diamond industry (1992) 21 J LEG STU 1, 115-57.

526 S Aslanian, Social capital, ‘trust’ and the role of networks in Julfan trade: Informal and semi-formal institutions at work, (2006) 1 J GLOB HIST 383-402.

framework that explains how institutions of this nature might currently operate across Latin American nations.

2. Reputational intermediation and adverse selection

As defined in Chapter II, informal institutions are mechanisms that encourage cooperative behaviour between parties engaged in sequential exchange. To accomplish this goal, informal institutions must give rise to credible mutual expectations between counterparties, which configures the element of 'trust' that is required for cooperation to take place. These mutual expectations are credible to the extent that they reduce the future payoffs of defection by either party, which allows them both to commit credibly to deal fairly with each other. In other words, exchange counterparties can 'trust' each other because informal institutions tie their economic welfare to their observable actions.[527]

This Section studies how reputational intermediation, an informal institution, can encourage cooperative behaviour between corporate insiders and outside investors in a way that neutralizes adverse selection in capital markets. Reputational intermediation is the process through which repeat players in capital markets pledge their reputational capital to investors in order to back up an assurance concerning certain facts or a future pattern of behaviour. Since these intermediaries expect to interact with investors multiple times over a long-term horizon, they have incentives to provide honest assurances and to comply with their commitments to investors. This allows intermediaries to build up a reputation—a term used here to denote outside expectations concerning their future

[527] As explained in Section 2 below, cooperative behaviour leads to financial rewards, while defection triggers a sanction.

behaviour—for fair dealing that enhances their ability to provide assurances in the future and, accordingly, reap the financial benefits of doing so.[528]

If, however, reputational intermediaries provide false assurances or fail to honour their commitment to investors, these intermediaries will suffer a reputational loss that has an impact on their future relations with investors. Investors may in fact place a lower value on the assurances provided by intermediaries that have breached their commitments in the past or even refuse to deal with those known for unfair dealings. Reputational intermediation works on the idea that the financial cost of this reputational loss will exceed any gains the intermediaries obtain from cheating investors at any specific juncture.[529]

The previous explanation hints at the ability of reputational intermediation to mitigate adverse selection in capital markets.[530] Recall that dealing with this market failure requires that investors have assurances that insiders in listed firms will limit self-dealing and disclose accurate information. The intervention of reputational intermediaries gives investors credible assurances that insiders will behave in this manner. Investors can rely on these assurances to the extent that the intermediaries are backing them up with their reputational capital—that is, if the expectations of investors are not met, an intermediary faces a financial loss that will exceed any immediate financial gains flowing to it.

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528 JE Stiglitz, Formal and informal institutions, (1991) 65.

529 B Black (2001); F Partnoy, Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime, (2001) 79 Wash. Univ. L. Quart. 490.

530 Mitigating adverse selection is just one possible function of reputational intermediation. See the discussions below for the potential role of reputational intermediaries in different contexts, including certification and validation services. See also RJ Gilson and R Kraakman, The mechanisms of market efficiency, (1984) 70 VIRG L REV 4, 549-644.

Reputational intermediation is usually associated with the work of gatekeepers such as underwriters, accounting specialists, law firms and stock exchanges.[531] Although gatekeepers provide a variety of certification services to investors, they can also be instrumental in helping the latter overcome adverse selection.[532] Before IPOs are launched, gatekeepers conduct a careful screening process to winnow out low quality offerors, namely, those that are not expected to live up to the assurances required by investors. After an IPO takes place, reputational intermediaries can ensure that listed firms continue to fulfil investor expectations concerning fair disclosure and the management of the company's affairs. For instance, in the TV Azteca case described in Chapter II, it was the firm's legal counsel that initially made public the irregular activities of the firm's controlling shareholder.[533] The screening and monitoring roles of gatekeepers are thought to be of some importance for the proper operation of stock markets.[534]

Although the traditional story of reputational intermediation focuses on the actions of gatekeepers, there are other parties that can perform a similar role in generating 'trust' between firms and investors. Both historical experience and recent accounts point to the potential role of certain types of controlling shareholders as reputational intermediaries. As explained in more detail below, families, prominent entrepreneurs, the

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531 JC Coffee and HA Sale, Securities regulation (11th ed, Foundation Press 2011); JC Coffee, Understanding Enron: It's about the gatekeepers, stupid, (2003) Columbia Law School Working Paper No. 207.

532 Among the various other services provide by gatekeepers one could mention their role in reducing the information costs of investors by sending credible signals about the value of their client's products, which gatekeepers accomplish when they 'stake [their] reputation on the value of the innovation'. See RJ Gilson and R Kraakman (1984) 549-644.

533 Still, lawyers are more often transaction engineers in the service of firms' needs than the defenders of investor interests. JC Coffee (2003).

534 See Macey (2010) for an account of how this reputational model may no longer be as relevant as it used to be in developed countries.

insiders of business groups and even the government can all take on this function. In their capacity as repeat players in local markets, these parties have incentives to build up their reputational capital in a manner similar to that of gatekeepers. Strong investments in reputational capital will allow these controlling shareholders to make credible commitments to investors about the disclosure practices and internal management of listed firms under their control.

To better understand the process through which different types of reputational intermediaries can neutralize adverse selection, it is useful to look at some examples gathered from the initial stages of financial development in industrialized nations. In the two cases outlined below, reputational intermediation supplied a measure of 'trust' that, in tandem with other factors, contributed to the growth of stock markets.[535] In the US example, gatekeepers assumed the role of reputational intermediaries in the context of a state with low levels of enforcement intensity.[536] Against a similar backdrop, the families atop *zaibatsu* groups in Japan supported informal relations of 'trust' between investors and firms under their control before the outbreak of the Second World War.[537]

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535 Aside from the two cases described here, reputational intermediaries appear to have been instrumental in the development of stock markets in Germany and the UK. In the first case, custodian banks arguably acted as intermediaries for outside investors. See C Mayer (2008). In the UK, the geographical proximity of investors and the intervention of gatekeepers helped develop informal relations of trust between firms and outside shareholders. See J Franks, C Mayer and S Rossi, Spending less time with the family: the decline of family ownership in the UK' in in *A history of corporate governance around the world* (R Morck (ed) University of Chicago Press 2005).

536 JC Coffee (2001b); F Partnoy (2001).

537 J Franks, C Mayer and H Miyajima, Evolution of ownership: The curious case of Japan (2007) available at http://www.hbs.edu/units/bgie/pdf/miyajima.pdf

A. Gatekeepers in US capital markets

The words *robber baron* show up regularly in modern accounts of the Gilded Age, a turbulent period in the history of the United States.[538] This title was used in reference to a group of prominent tycoons—Cornelius Vanderbilt, J.D. Rockefeller, Jay Gould, the Van Sweringen brothers and others—who controlled the largest public firms in the US at different times between the end of the American Civil War and the first decades of the 20th century.[539] Although these entrepreneurs contributed greatly to the industrial development of the US, they were often mired in controversy.[540] These individuals 'controlled the majority of votes in vast corporate empires with relatively small(er) amounts of capital…leaving ample room for self-dealing'.[541]

During the era of the robber barons, the formal institutional framework meant to protect outside investors in the US was noticeably weak. The problem, as explained by

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538 The term 'robber baron', a derogatory epithet used in reference to famed American industrialists and financiers of the 19th century, may have appeared for the first time in an article on Cornelius Vanderbilt published by E.L. Godkin on the November 18, 1869 issue of *The Nation*. Godkin used this label to evoke 'the mediaeval barons that we read about…' (H Bridges, 'The Robber Baron Concept in American History', (1958) 32 BUS HIST REV 1). In turn, the label 'Gilded Age' originated in the works of Mark Twain (more specifically, in a book of the same name written with Charles Dudley Warner) and refers to a period in US history that spans from the years that followed the American Civil War until the first decades of the 20th century. See also T Grayson, *Leaders and Periods of American Finance* (John Wiley and Sons, New York 1932); M Josephson, *The Robber Barons: The Great American Capitalists* (Harcourt, Brace and Co., New York 1934) and T Brewer, *Robber Barons: Saints or Sinners?* (Holt, Reinhart and Winston, New York 1970).

539 Robber Barons were 'aggressive men, as were the first feudal barons; sometimes they were lawless; in important crises, nearly all of them tended to act without those established moral principles which fixed more or less the conduct of the common people of the community'. M Josephson, (1934) vii. For the full list of Robber Barons, see F Redlich, 'The Robber Baron: Creative and Destructive' in T Brewer (1970) 91.

540 For instance, Jay Gould was once thought to be the most hated man in the US: 'during the terrible closing hours of Black Friday [September 24, 1869] he had faced the howling raging mob of ruined brokers who went in search of him with murder in their hearts when driven by his cold-blooded and triumphant operations out of the New York Stock Exchange, crazed and broken men'. T Grayson (1932) 332. See also J Markham, *A Financial History of the United States* (vol. I, M.E Sharpe, New York 2002) 251, 264. For a more positive view of Robber Barons, see discussions in T Brewer (1970).

541 M Becht, P Bolton and A Röell (2003) 6.

some commentators, was not the lack of substantive legal rules but rather the poor levels of enforcement.[542] Influential individuals could easily hold sway over courts and lawmakers, which negated attempts by investors to rely on the state for the protection of their interests as minority shareholders.[543] These deficiencies, added to the presence of dominant controlling shareholders, could have easily magnified adverse selection and stunted stock market growth. Historical data indicate that this, however, was not the case.

Average daily trading volumes at the New York Stock Exchange increased from 1,500 shares in 1861 to more than 500,000 in 1900 and annual trading volumes grew from estimates of 80 million shares in 1897 to 265 million in 1901.[544] The number of listed firms in the NYSE grew from 691 in 1920 to over 1,000 in under six years, while annual trading volumes had already exceeded 1 billion shares by 1929.[545] Ownership had already started to disperse in NYSE-listed firms well before the enactment of the Securities Act (1933) and the Securities Exchange Act (1934).[546]

The rapid development of US capital markets during this period has been attributed in part to the intervention of reputational intermediaries. First, the NYSE, in its capacity as a self-regulatory organization (SRO), undertook to ensure the quality of the firms it admitted for a public listing.[547] The exchange set in motion a legal system in miniature, 'with its own rules governing securities trading and its own mechanism for

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542 According to Coffee, outside investors were vulnerable 'less because of the substantive inadequacy of American corporate law itself tan because of the lack of enforcement mechanisms and the prospect of corruption'. JC Coffee (2001b).

543 G Myers, 'The Moguls Manipulate Congress' in T Brewer (ed) (1970) 76; FL Allen (1935) 253.

544 J Markham (2002) 3.

545 Id 124.

546 JC Coffee (2001b).

547 BR Cheffins (2003) 11; JC Coffee (2010) 40.

resolving trade-related disputes'.[548] This system was considered to be of such high quality that, for instance, the disclosure standards that the NYSE imposed on its listed firms would serve as a model for the securities reforms of the 1930's.[549] By designing and enforcing this system of rules, the NYSE provided assurances to outside investors concerning the accuracy of disclosure and the governance of its listed firms.[550] Firms that failed to comply—or were not expected to comply—with the NYSE's listing requirements were not admitted to the exchange; those that violated the rules after an IPO were forcefully delisted.[551] In doing this, the NYSE dealt with adverse selection to an extent that the state was unable to emulate at the time.[552]

The NYSE had powerful incentives to live up to its role as a reputational intermediary. If the exchange's listing rules were seen to be inadequate or under-enforced, it would suffer a reputational loss in its capacity as a gatekeeper. This would reduce the exchange's ability to provide assurances concerning the quality of its firms, which could lead investors to apply discounts to NYSE shares or even turn them away from the stocks issued by NYSE firms. The loss of reputational capital therefore had the potential to lead to the downward spiral described in Chapter II as a 'lemons equilibrium', with disastrous consequences for the exchange. This reputational damage

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548 S Banner, 'Anglo-American Securities Regulation: Cultural and Political Roots: 1690-1860' (1998) quoted by JC Coffee (2001b) 51.

549 The restrictions set up by the NYSE on the issuance of dual class shares were also emulated by numerous other stock exchanges. Id 37.

550 The NYSE would 'regularly reject issuer applications, either because the issuer lacked an adequate earnings track record, had insufficient assets, or was in an industry characterized by high risk. In so doing, the NYSE was also able to distinguish itself from its American competitors and present an image to investors as the most reputable Exchange'. JC Coffee (2001b).

551 According to Macey (2010), the threat of delisting 'had draconian effects on companies because of the lack of alternative trading venues for shares in public companies'.

552 Chapter V develops this point further in the context of the substitution and complementarity effects between formal and informal institutions.

would exceed any gains the exchange might derive from granting access to a low-quality company or from overlooking the offences of a listed firm.[553] This was one of the reasons the NYSE went to such great lengths to update and enforce its listing rules.[554] In doing so, the exchange became the 'dominant provider of reputational capital' in the US for many decades.[555]

At the time the NYSE was acting as a gatekeeper for listed firms, another type of reputational intermediary also operated in US capital markets. Specialized brokers that underwrote share offerings for NYSE IPOs developed a system of bonding through which they would pledge their reputational capital as a guarantee for the quality of their client's securities.[556] This pledge was backed by two specific measures. First, the partners at major underwriters became members of the board of directors in the listed firms that they advised.[557] This allowed them to closely monitor the firm's activities and intervene to correct managerial deficiencies.[558] Later, as share ownership dispersed, the presence of these individuals in corporate boards protected firms from predatory raiders who were unwilling to pay a control premium to incumbent shareholders.[559] Second, investment bankers conducted a screening process to assess the quality of potential issuers.

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553 J Macey and H Kanda, The stock exchange as a firm: The emergence of close substitutes for the New York and Tokyo Stock Exchanges, (1990) Yale Law School Faculty Scholarship Series Paper No. 1720, 1023.

554 The NYSE in fact 'strove to enhance and protect its reputational capital'. JC Coffee (2001b). However, the author points to the existence of economic factors that were arguably more important in the NYSE's decision to cater to high-quality firms, including its limited member base, fixed-commission system and cartel-like organization.

555 J Macey and H Kanda (1990).

556 'The involvement of financial professional when companies sold shares to the public also served to create an expectation of fair dealing among US investors'. BR Cheffins (2003) 11.

557 JC Coffee (2001b).

558 Id.

559 Id.

Accordingly, when these underwriters decided to back a particular offering they were effectively putting their reputation on the line to vouch for the quality of their clients.[560]

In sum, the intervention of the NYSE and underwriters helped investors overcome adverse selection in the early development stages of US capital markets. The activities of these reputational intermediaries were more fully regulated through the securities reforms of the 1930's, as described in Chapter V.[561] Although there is some controversy concerning the current role of gatekeepers and the fading importance of their reputational incentives in modern US markets, there is also general agreement as to their significance during the initial development of capital markets in this jurisdiction.[562]

B. Zaibatsu family groups in Japan

Japanese finance underwent major changes over the past century. Economists divide Japan's financial history intro three distinct periods.[563] The first one started towards the end of the 19th century and led up to the outbreak of the First World War. During this period, despite the weakness of outside investor protection, there was a significant level of activity in Japanese capital markets. The second period, which includes the interwar years, features the rise of the *zaibatsu* family groups in the context

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560 See also RJ Gilson and R Kraakman (1984) for an explanation of how investment banks send signals about the quality of an issuer's products and future prospects.

561 JC Coffee and HA Sale (2011).

562 F Partnoy, Strict Liability for Gatekeepers: A Reply to Professor Coffee, University of San Diego legal Studies Research Paper No. 05-21 (2004) (arguing in favour of a modified strict liability regime for gatekeepers). Partnoy considers that reputation is a 'suboptimal constraint' for gatekeepers in the US: 'Reputation is one of many assets in a gatekeeper's portfolio, to be depleted when the marginal benefits of doing so exceed the marginal costs' (Id. at 2). On gatekeeper failure, see JC Coffee (2003). On the historical importance of reputational intermediaries and the modern decline of the reputational model in industrialized countries, see J Macey (2010).

563 J Franks, C Mayer and H Miyajima (2007).

of active stock markets and a mild degree of ownership dispersion.[564] The final period starts at the end of the Second World War. It features the dismantling of the *zaibatsu* groups by the Allied Forces, momentous improvements to the formal institutional framework in Japan and a move towards a bank-centred system of finance.[565]

The operation of Japanese capital markets during the interwar years is particularly relevant to the study of informal institutions. During this period, equity issuances were a significant source of finance for Japanese firms.[566] The average number of shareholders in listed firms rose substantially, from 3,000 in 1921 to more than 5,000 at the end of the 1930's.[567] By most available indicators, Japanese equity markets were flourishing around the outbreak of the Second World War.[568]

The rapid development of stock markets in Japan during the interwar period took place against a backdrop of weak formal institutions.[569] Despite substantive reforms to corporate laws in 1911—which set out information reporting obligations and imposed a disclosure-related fiduciary duty of care on directors—the level of investor protection in Japan remained significantly low until new reforms were introduced first at the end of the 1930's and then some years later, under the control of the General Headquarters of Allied Nations after the end of the Second World War.[570]

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564 F Allen and others (2011). There is some ambiguity concerning the definition of the word *zaibatsu*. For a detailed explanation of what the term means, see R Morck and M Nakamura, 'A frog in a well knows nothing of the ocean: A history of corporate ownership in Japan' in *A history of corporate governance around the world* (R Morck (ed) University of Chicago Press 2005).

565 T Hoshi and A Hashyap, Corporate financing and governance in Japan (MIT Press 2001).

566 F Allen and others (2011).

567 J Franks, C Mayer and H Miyajima (2007).

568 R Rajan and L Zingales, The great reversals: The politics of financial development in the twentieth century, (2003) 69 J FIN ECON 5.

569 R Morck and M Nakamura (2005).

570 J Franks, C Mayer and H Miyajima (2007).

Aside from the weakness of the formal institutional framework, the interwar period was also marked by the dominance of the *zaibatsu*, business groups controlled by local families.[571] These corporate groups required 'capital vastly in excess of their own wealth', which moved them to repeatedly raise equity from investors in Japanese stock markets.[572] *Zaibatsu* were also organized as pyramids, a corporate structure that has traditionally been censured due to its multiplying effect on agency costs.[573]

A pyramidal group consists of a vertical cluster of firms subject to joint control at the highest level of the group. One of the main consequences of this corporate structure is that is separates the voting power of controlling shareholders from their cash flow rights, in the manner described at the end of Chapter III. For example, assume an individual controls a firm at the top of pyramidal group [Firm A] by holding more than half of its outstanding ordinary shares [i.e., 50.1%]. The remaining shares issued by Firm A are owned by outside investors and traded in a stock exchange. Firm A, in turn, has a controlling stake in another listed company [Firm B], in which it holds 50.1% of all available ordinary shares. Once again, the shares in Firm B that are not owned by Firm A have been acquired by outside investors. Finally, Firm B holds a controlling percentage [50.1%] of the ordinary shares issued by another listed entity [Firm C], which again has placed its remaining shares in the hands of third parties.

By setting up this corporate structure, the fictional individual in this example indirectly controls Firms B and C with voting rights that do not match her economic stake in these firms. In fact, despite being entitled to cash flows that amount approximately to

571 R Morck and M Nakamura (2005).

572 Id. at 368.

573 J Franks, C Mayer and H Miyajima (2007).

25.1% in Firm B and to 12.5% in Firm C, this hypothetical blockholder has the ability to determine the outcome of every voting contest in the shareholders' assemblies of both firms.

The use of pyramidal structures such as those used by *zaibatsu* families aggravates the agency problem between controlling and minority shareholders discussed in Chapter II.[574] The individuals at the top of the pyramid have full control over every firm in the pyramid and can therefore impose their will on outside investors. However, these controlling parties do not bear a majority share of the wealth effects generated by their decisions, due to their minority cash flow stakes at the lower levels of the pyramid—a situation similar to the one generated by the issuance of non-voting stock explained in Chapter III.[575] The controlling shareholders of pyramidal groups are therefore highly likely to engage in tunnelling.[576]

The dominance of *zaibatsu* pyramidal groups in Japan between 1918 and 1939, coupled with the lack of investor protection during this same period, would in theory create the perfect conditions for a 'lemons equilibrium' to prevail. There is in fact some evidence of tunnelling by the controlling families of these groups at the time.[577] As mentioned above, however, stock markets developed rapidly in Japan during the interwar years. In order to reconcile these seemingly contradictory facts, some authors point to the

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574 R Morck, D Wolfenzon and B Yeung (2005) 720; M Becht, P Bolton and A Röell, 'Corporate Governance and Control' in GM Constantinides, M Harris and RM Stulz (eds) *Handbook of the Economics of Finance* (Vol. 1, Elsevier, Amsterdam 2003); LA Bebchuk, R Kraakman and G Triantis (2000) 318.

575 TY Yen and P André (2007).

576 To boot, their incentives to maximize firm value by monitoring managers or running the firm directly will be decreased.

577 R Morck and M Nakamura (2005).

role of *zaibatsu* groups in promoting informal relations of trust.[578] Instead of leading to minority expropriation, the presence of controlling families in these corporate groups arguably attracted outside investment. This may have been due to several different reasons.

The available evidence suggests that *zaibatsu* families often engaged in the value-maximizing activities described in Chapter II. There are, for instance, documented instances of propping when group subsidiaries were in distress.[579] Controlling families were also particularly adept at monitoring managers across the companies in the pyramid, a feature that became particularly important as non-*zaibatsu* firms faltered at the end of the 1920's.[580] Some authors also point to the efficiency gains tied to intra-group transactions and to the favourable dividend policies adopted by some group firms, as reasons for investor interest in the *zaibatsu*.[581] The fact that these business groups usually received substantial government funds or monopolistic powers may have also contributed to stir up the interest of outside investors for their securities.[582]

Even if *zaibatsu* groups had some or all of these advantages, there was no guarantee that controlling shareholders would share a fair portion of the firm's benefits with minority investors. Recall that these parties had both the incentives (exacerbated by pyramidal structures) and the opportunity (created by the weakness of the legal system) to appropriate firm resources. The widespread participation of outside investors in *zaibatsu* groups may therefore speak to the development of informal relations of 'trust' in

578 F Allen and others (2011); J Franks, C Mayer and H Miyajima (2007).

579 F Allen and others (2011).

580 J Franks, C Mayer and H Miyajima (2007).

581 Id; A Goto, Business groups in a market economy, (1982) 19 EUR ECON REV 53.

582 F Allen and others (2011).

Japanese capital markets at the time. Some authors suggest that the mechanism at work here was the desire of controlling families to 'preserve their reputation'.[583] In fact, these individuals may have been ideally placed to act as reputational intermediaries for the firms under their control.

The large capital needs and dividend distribution policies of *zaibatsu* groups forced them to return frequently to the stock market for new equity issuances.[584] In their condition as repeat players in capital markets, the controlling families at the head of these groups had incentives to build up a reputation for fair dealing with outside shareholders. This allowed them to provide ex ante assurances as to the manner in which the group would conduct its business, which lured investors to new equity issuances.

At the same time, inaccurate disclosure practices or substantial tunnelling had the potential to inflict reputational damage on *zaibatsu* families.[585] Reputational loss would have reduced their ability to provide the assurances required by the market, which in turn would have led investors to discount the price paid for the shares issued by any group subsidiary or to altogether refrain from participating in an IPO sponsored by the group. As a consequence, the reputational damage inflicted on *zaibatsu* controlling shareholders for inaccurate disclosures or tunnelling might have exceeded any one-time profit obtained from this behaviour.

Even if the previous pattern fits within the contours of reputational intermediation, the available evidence is not conclusive as to the actual motivations of the families in control of *zaibatsu* groups. Other factors such as cultural mores or social cohesion might

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583 J Franks, C Mayer and H Miyajima (2007). See also T Khanna and Y Yafeh (2007).

584 J Franks, C Mayer and H Miyajima (2007).

585 This reputational damage could reach significant levels if controlling shareholders did not engage in positive acts such as monitoring, propping and fair dividend distributions.

have played an important role in generating trust between controlling shareholders and investors. Moreover, some historical accounts paint a picture of *zaibatsu* groups as mere instruments for the expropriation of outside shareholders.[586] However, the Japanese experience with *zaibatsu* families does provide some insights for the study of the potential role of controlling shareholders as reputational intermediaries. To this we turn next.

3. The controlling shareholder as reputational intermediary

The starting point for this analysis goes back to the question posed in Chapter II. Why do we observe outside investors in jurisdictions in which controlling shareholders have few formal limits on their ability to behave opportunistically? Leaving aside the constraints imposed by the formal legal framework, which are particularly weak across developing countries, it has been suggested that controlling shareholders voluntarily limit expropriation to an extent acceptable to minority investors.[587] However, this explanation merely leads to a new question, namely, what mechanism is at work to encourage this sort of behaviour?[588]

The following discussions seek to provide some answers to this question by looking at situations in which controlling shareholders in developing countries become repeat players in capital and product markets. When this happens, as in each of the three

[586] See, for instance, R Morck and M Nakamura (2005) for a more negative view of *zaibatsu* groups.

[587] HC von der Crone and E Plaksen (2010) 15; RJ Gilson (2007).

[588] T Khanna and Y Yafeh (2007) suggest that the literature does not provide clear answers to the question of why investors acquire minority shares in certain types of firms with controlling shareholders.

models described below, these parties are in a position to act as reputational intermediaries for the firms under their control.

The importance of reputational intermediation lies with the credibility of the assurances that controlling shareholders provide to investors and other constituents concerning the manner in which they will conduct the affairs of the firm. The assurances will remain credible as long as controlling shareholders stand to gain more from meeting the expectations of investors than from breaking their commitments. As explained earlier, credible assurances such as these are essential to mitigate the acute adverse selection problem of stock markets in developing countries.

A. The liquidity and diversification advantage model

An early effort to explain the positive behaviour of controlling insiders in emerging countries assumes that these parties return repeatedly to the stock market in order to reduce liquidity costs and idiosyncratic risk.[589]

Liquidity costs are tied to the size of an insider's block of shares. Blockholding limits the amount of stock available for trading in secondary markets and therefore has an impact on a shareholder's ability to rapidly sell her shares 'at or near the market price'.[590] To this extent, owning large blocks of shares creates a liquidity cost for the controlling shareholder.[591] Public offerings increase the amount of shares available for trading and

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589 A Gomes (2000).

590 BR Cheffins (2008) 65. See also P Bolton and EL von Thadden, Liquidity and control: A dynamic theory of corporate ownership structure' (1998) 154 JITE 177, 211.

591 CF Foley and R Greenwood, The evolution of corporate ownership after IPO: The impact of investor protection' (2010) 23 REV FINAN STUD 1231, 1260

expand the number of potential buyers for the shares held by insiders, which can reduce the liquidity constraints of these parties.

Non-diversification costs arise due to the concentration of the controlling shareholder's risk exposure in a single firm.[592] By holding a large equity stake in a listed company, the controller becomes particularly vulnerable to firm-specific risks of a non-systemic nature. If, for instance, the industry in which a company operates is in the midst of a recession, a shareholder with a significant stake in the firm will bear much of the resulting loss. Accordingly, well-diversified investors are at less risk of loss than those who hold large blocks of shares in a single firm.[593] The issuance of shares through public offerings allows the blockholder to diversify her downside exposure by spreading the firm's idiosyncratic risk amongst outside investors.[594]

The liquidity and risk diversification advantages of public offerings are thought to be of some relevance for controlling shareholders.[595] Despite the availability of different means to accomplish these same goals (i.e. risk diversification at the company level), there is evidence that share issuances by listed companies in emerging jurisdictions are motivated to some extent by the desire of controlling parties to reduce firm-specific risk and liquidity costs.[596] Some go so far as to suggest that the main role of equity markets is

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592 BA Ødegaard (2009); BR Cheffins (2008); H Demsetz and K Lehn, The structure of corporate ownership: Causes and consequences' (1985) 93 J POLIT ECONOMY 1155, 1177.

593 A Bodnaruk and others, Shareholder diversification and the decision to go public, (2008) 21 REV FINAN STUD 2779, 2824.

594 A Gomes (2000).

595 Public issuances can also take place when entrepreneurs seek to gather strategic information about specific business units within a firm. Under this view, corporate subsidiaries are listed as a means to profit from 'market generated information on the relative value of the unit as an independent firm'. See E Perotti and S Rossetto, Unlocking value: Equity carve outs as strategic real options' (2007) 13 J CORP FIN 785.

596 S Chernenko, CF Foley and R Greenwood (2010); JC Coffee, Dispersed ownership: The theories, the evidence and the enduring tension between "Lumpers" and "Splitters", Columbia Law and

'not to provide financing to firms, but to provide owners with the ability to diversify idiosyncratic risks and to provide them with liquidity'.[597]

Starting from this premise, this model assumes that at the time of an IPO (i) investors face a severe 'lemons' problem because formal institutions are too weak to constrain the behaviour of insiders and (ii) due to incomplete information, controlling shareholders cannot rely on pre-IPO facts to provide investors with assurances as to their future behaviour.[598] Faced with an acute adverse selection problem, investors will apply a severe discount to the price they pay for the shares at the time of the IPO. This discount creates an incentive for the controlling shareholder to divest only a small portion of her holdings at this stage.[599]

After the IPO has taken place, the controlling shareholder will strategically choose to limit the observable amount of private benefits extracted from the firm. This allows her to build a reputation for fair dealing with outside investors. The reason for this behaviour is tied to the effect that the controlling shareholder's reputational capital will have on investors. As outsiders start to rely on the controller's reputation for fair dealing, they will be willing to reduce the severity of their discounting strategy in future share offerings. At this point, the controlling shareholder can divest another portion of her holdings in order to shed liquidity costs and firm-specific risk under more favourable conditions (i.e. lower discount) than at the time of the IPO. Continued good behaviour

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Economics Working Paper No. 363/2010 http://ssrn.com/abstract=1532922 (with regard to liquidity costs for investors).

597 A Gomes (2000).

598 This explanation is loosely based on A Gomes (2000).

599 After this point, the controlling shareholder 'can credibly commit not to divert the [firm's] cash flows because if he started to extract high levels of private benefits from the IPO, investors would discount the price of shares accordingly, and the [controlling shareholder's] remaining shares would sell at a reduced price'. Id. at 629.

after this stage will lead to further increases of the controller's reputational capital and to corresponding reductions of the amount discounted by investors in future share offerings. As a result, controlling shareholders have an incentive to develop a reputation for fair dealing with outside investors in order to shed liquidity costs and firm-specific risk through consecutive rounds of share offerings.[600]

Under this model, controlling shareholders act as reputational intermediaries after an IPO has taken place. Since they are expected to return to the market for successive share offerings, controlling shareholders have incentives to build up a reputation for fair dealing that will allow them to provide credible assurances to investors as to the manner in which the firm's affairs will be managed. Observed instances of misbehaviour will impact on the ability of insiders to provide credible assurances, which would lead investors to discount the price paid for the firm's shares in future offerings. This would make it more expensive for the controller to reduce liquidity costs and idiosyncratic risk through successive rounds of share offerings. As long as this extra cost exceeds any potential gains from unfair dealing, controlling shareholders will continue to curb the observed expropriation of minority shareholders.

This last assertion points to the limits of the model described here. Each offering dilutes the stake of the controlling shareholder in the firm, so that these insiders can only issue a certain number of shares before effectively losing control. In developing countries, the threshold at which control will become contestable usually stands at 50.1% of the firm's outstanding shares. As the controller's stake reaches this threshold, she will no longer find it rational to invest in her reputational capital since she does not expect to

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600 A Gomes (2000) suggests that 'the mechanism that allows the reputation effect to work is the prospect of selling additional shares in the future for a higher price'.

return to the market for another share offering.[601] This last-period problem places a clear limit on the role of the controlling shareholder as a reputational intermediary under this model.

However, mechanisms that separate voting and cash flow rights, such as dual class shares and pyramids, can extend interactions beyond the period at which controllers reach the 50.1% threshold. As illustrated by the example of the pyramidal holdings used by the Japanese *zaibatsu*, structures of this nature allow insiders to sell a majority portion of the firm's cash flow rights without losing voting control. This possibility extends the number of future share offerings, which preserves the incentives of controlling shareholders to build up their reputation at least until the final period approaches again.[602]

B. The product market advantage model

Another explanation put forward to explain the self-imposed limits on the behaviour of controlling shareholders is related to the reduction of trading costs in product markets.[603]

This model assumes that insiders take on outside investors to credibly signal fair dealing to their commercial counterparties. Poor commercial law in emerging countries makes it a necessity to conduct business through repeated interactions between trading partners.[604] The reputation of insiders plays a central role in these interactions. As the

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601 See J Macey (2010) for a similar explanation of the last period problem in a related context.

602 Note, however, that this separation of voting and cash flow rights also aggravates the agency problem between controlling shareholders and outside investors.

603 This model is developed in RJ Gilson (2007).

604 R Gil and J Marion, The role of repeated interactions, self-enforcing agreements and relational (sub) contracting: Evidence from California highway procurement auctions, (2009) University of California Working Paper http://people.ucsc.edu/~rgil/Gil_Marion_Oct09.pdf; RJ Gilson (2007).

firm's trading counterparties observe the actions of controlling shareholders, they will readjust the conditions under which they deal with the firm to match the expected future behaviour of these insiders.[605] This readjustment can either increase or decrease the firm's cost of trading in product markets.[606] These costs flow mainly from variations in the firm's trading volumes and commercial opportunities as well as from its need to provide executable guarantees or costly bonding mechanisms to carry on doing business.[607]

When insiders have no established reputation or are known to cheat on their counterparties, the firm will have high trading costs. Conversely, a firm with an insider renowned for fair dealing will reap financial benefits through a reduction of its costs of trading in product markets.[608] The positive and negative financial effects endured by the firm feed back to controlling shareholders through their majority equity stakes and their prospects for private benefit extraction. This is due to the fact that all the value that flows from the firm to its controlling shareholders is ultimately tied to the company's economic performance. If the firm's financial situation deteriorates due to increased trading costs, insiders will bear most of the resulting losses in the form of lower dividends and a

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605 J Armour, C Mayer and A Polo (2010; JM Karpoff, DS Lee and GS Martin (2008). It has been argued that for this readjustment to take place, the firm's counterparties in product markets must be able to clearly observe how controlling shareholders behave towards outside investors. This may not be an easy task to accomplish unless a mechanism for the centralized diffusion of public information about the behaviour of insiders is in place. However, even the presence of this mechanism might not be sufficient to solve the problem noted above. See Chapter V for a discussion of these issues.

606 For discussions on the importance of reputation in the field of corporate law, see B Black (2009); JM Karpoff, DS Lee and GS Martin (2008); B Liebman and C Milhaupt (2008); CR Alexander (1999) 526; JM Karpoff and JR Lott (1993).

607 RJ Gilson (2007).

608 Id.

reduced scope for the extraction of private benefits. Similarly, controlling shareholders will capture most of the monetary gains tied to reductions in the firm's trading costs.

As this system of trading relies on the expected actions of controlling shareholders, these parties act as reputational intermediaries between the firm and its commercial counterparties.[609] In order to build up their reputational capital, controlling shareholders take on outside investors and voluntarily limit the amount of tunnelling that is observable to outsiders. 'Fair treatment of minority shareholders then serves as evidence of the corporation's integrity, including its commitment to performing its contractual obligations'.[610]

This model has been criticised on several grounds. For instance, since the goal of controlling shareholders is to reduce the firm's trading costs, it is unclear why they would take the indirect route of showing good behaviour towards investors in capital markets instead of just displaying this behaviour directly in product markets.[611]

Another criticism suggests that the information about the dealings of insiders with outside investors might not reach the firm's counterparties in product markets.[612] In order for the readjustment of trading conditions to take place, the firm's counterparties in product markets must be able to clearly observe how controlling shareholders behave

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609 BR Cheffins (2008) 62; RJ Gilson (2007). This model assumes that controlling families are particularly good as long-lived reputation bearers.

610 RJ Gilson (2007) 648. The author also suggests that there additional product market advantages to developing a reputation for fair dealing with outside shareholders: 'There is good reason to think that the capital market signal of product quality sent by the treatment of minority shareholders adds to a customer's information set concerning product quality'. Id at 650.

611 SY Kang, Reenvisioning the controlling shareholder regime: Why controlling shareholders and minority shareholders embrace each other, (2011) Columbia Law School, available at http://alturl.com/fbunv. One possible explanation is that the reputational mechanism works best in the context of capital markets, where there is a continuous flow of detailed firm-related data and possibly a regulator or centralized agency that publicises information about insider misbehaviour.

612 See SY Kang (2011).

towards outside investors. This may not be an easy task to accomplish unless a mechanism for the centralized diffusion of public information about the behaviour of insiders is in place.[613] However, even with this mechanism in place, there would still be no assurances that the firm's counterparties would be able to observe the actual behaviour of insiders. In fact, insiders may just go to greater lengths than before to cover up their unfair dealings towards outside investors. To boot, the benchmarks against which the behaviour of insiders is assessed (i.e. norms, legal rules) may not reflect actual instances of fair dealing. Chapter V examines these problems in more detail.

C. The cost of capital advantage model

This model works in a similar way to the first two models. The central assumption here is that firms will regularly use stock markets as a financing mechanism. By selling shares to myriad outside investors, the story goes, firms can tap into a relatively cheap source of finance to undertake new projects or expand industrial capacity.[614] After the firm has gone public, outside investors will observe the actions of controlling shareholders and readjust the conditions under which they deal with the firm to match the expected future behaviour of these insiders.

In the context of stock markets, the readjustment of trading conditions will have an impact on the firm's cost of capital. Outside expectations concerning the behaviour of insiders will lead investors to adjust the discount applied to the firm's shares during

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613 J Armour, C Mayer and A Polo (2011).

614 RD Cooter and HB Schaefer (2012). See also S Chernenko, CF Foley and R Greenwood (2010). W Kim and M Weisbach, Do firms go public to raise capital?, NBER Working Paper No. 11197/2005 http://www.nber.org/papers/w11197. Firms can also raise equity in order to reduce their debt exposure and reduce the cost of bank finance. M Pagano, F Panetta and L Zingales, Why do companies go public? An empirical analysis, (1998) 53 J FINANCE 27, 64.

future share offerings. The prospective variations in the firm's cost of capital—tied to the magnitude of the discount—create an incentive for controlling shareholders to invest in building up their reputation for fair dealing, which sets in motion the chain of events described in the first two models above. In other words, the 'expected decrease in the price paid in the next offering would decrease the incentive to divert following the first'.[615] This incentive structure places controlling shareholders in an ideal position to act as reputational intermediaries for firms under their control.

The central problem with this model is that it assumes that controlling shareholders will return frequently to stock markets to satisfy their capital needs. However, it has been suggested that this may not be the case across developing countries.[616] One of the implications of the 'pecking order' theory of finance is that information asymmetries between the firm and outside investors make it rational for insiders to tap into different sources of capital in a specific sequence.[617] The sequence follows, among other things, the degree of riskiness that each source of finance poses to potential financiers, which has an impact on the firm's ability to draw cash flows from these sources.

The pecking order thus places internally generated funds as the firm's first option, since tapping into these resources does not involve bringing in new creditors or investors. The sequence then moves on to debt finance and only in the final instance, when the two previous sources have been insufficient to fund the firm's activities, are insiders expected

615 RJ Gilson (2007) 646.

616 Id.

617 J Glen and A Singh (2004).

to resort to the public issuance of shares, the source of capital that poses the highest risk to potential financiers.[618]

The pecking order theory seems to hold true in those countries with the largest and most active stock markets, such as the US and the UK, where firms raise in aggregate only a 'modest amount of [equity] finance'.[619] Certain features of developing countries, including the deficiencies in the framework of formal institutions, should make the pecking order sequence even more immutable in these jurisdictions.[620] This would make it highly unlikely for controlling shareholders in emerging countries to return repeatedly to the stock market in pursuit of equity capital.

In practice, however, the controlling shareholders of business groups often become repeat players in capital markets across emerging countries.[621] This pattern of behaviour may be tied to three factors that jointly push business groups to raise equity: (i) the incentives of corporate insiders to engage in empire-building, (ii) the gradual increase in the availability of equity as a new source of finance in emerging countries, and (iii) the signalling advantages that groups have over stand-alone firms to tap into equity resources.

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618 RJ Gilson (2007).

619 C Mayer (2008) 621. The author also points out that equity finance is important in these jurisdictions for 'financing small rapidly expanding firms…funding acquisitions by large firms'. Id.

620 A Singh, Corporate governance, corporate finance and stock markets in emerging countries, (2003) 3 J CORP L 1, 41-72.

621 For data on the extent to which corporate groups participate in developing capital markets, see RW Masulis and others, Family Business Groups around the World: Financing Advantages, Control Motivations, and Organizational Choices (2012) 25 REV FIN STUD 4. For data on the importance of family groups in Latin America, see Chapter VI.

(i) Empire-building

One of the manifestations of the managerial agency problem present in firms with dispersed ownership is the inclination of insiders to create or preserve conglomerates 'with few economies of scale or scope to give them economic purpose'.[622] The problem of empire-building has been attributed to the private benefits managers obtain from controlling a large conglomerate, which leads them to use the firm's free cash flows in a self-serving manner.[623]

Empire-building is also prevalent across developing countries, where ownership concentration shifts the locus of power from managers to controlling shareholders. Controlling shareholders have considerable incentives to set up and expand business groups.[624] For instance, as explained in Chapter II, the high amenity value of controlling a business group creates incentives for insiders to engage in empire-building.[625] To this effect, controlling shareholders can obtain considerable social and political rewards from being the heads of a major business group. If, as it is usually the case, the group happens to be a dominant force in the local economy, its controlling shareholder would enjoy a particularly privileged position, similar to that of a king in a small realm.[626]

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622 MC Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, (1986) 76 AMER ECON REV 2, 328.

623 LA Bebchuk, The Case for Increasing Shareholder Power, (2005) 3 HARV L REV 118.

624 LA Bebchuk, R Kraakman and G Triantis (2000) (discussing these incentives in the context of pyramidal business groups).

625 SY Kang (2011).

626 O Ehrhardt and E Nowak (2003) 4. See Chapter VI for anecdotal evidence of the multiple benefits captured by the heads of the major Latin American *grupos*.

Empire-building is also driven in emerging countries by the 'internal market' benefits associated with corporate groups, as described in Chapter I.[627] Recall that these benefits substitute for shortcomings in the enforcement of contracts, the deficiencies of labour and product markets, and the limited supply of external finance in developing jurisdictions.[628] The expansion of a business group can enhance the 'internal market' benefits captured by the group's affiliates. However, as expanding a group is likely to be a costly endeavour, insiders will probably use every source of finance available to them, including internal funds, bank loans and all the equity capital that becomes available due to the expansion of local stock markets.

(ii) Increased availability of equity

Although firms in emerging countries have traditionally relied on internally generated funds and related lending to fund their operations, the gradual expansion of stock markets has made available an increasing amount of equity capital. These new resources come not only from local retail and institutional investors, but also from the increased presence of foreign investors in these jurisdictions. For instance, one study suggests that during the 1980's and 1990's, firms in Eastern Asia relied more on equity than on debt and resorted to external finance to a larger extent than to internal resources.[629]

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627 See also Chapter VI. For a review of the extensive literature produced on this topic, see T Khanna and Y Yafeh (2007).

628 T Khanna and Y Yafeh (2000).

629 S Deakin (2010) 205; A Singh, Are the institutions of the stock market and the market for corporate control evolutionary advances for developing countries? (2010) MPRA Working Paper No. 24346; J Glen and A Singh (2004); A Singh (2003).

As explained in Chapter I, Latin American firms have started to rely more heavily on external finance over the past years, with banks supplying the majority share of the resources used by firms in the region. Although banks are still the main providers of finance in Latin America, the growth of capital markets in Brazil, Chile, Colombia, Mexico and Peru has increased the pool of equity capital available for firms operating in these countries.[630] Following the data that will be presented in Chapter VI, this new source of finance has mostly favoured the controlling shareholders of family-owned business groups in these Latin American countries. Although one of the 'internal market' benefits of groups is the ability to use intra-group funds (i.e. internally generated funds or debt from affiliated banks), equity finance might also be an important catalyst for the expansion of these organizations.[631]

However, business groups usually have to compete with stand-alone firms for a share of these newly available equity resources. To this effect, access to equity finance in developing stock markets may be cheaper for business groups than for stand-alone firms due to the signalling advantage of group structures, as explained next.

(iii) The signalling advantage of business groups in capital markets

As stock markets start to develop in emerging countries, groups may have a signalling advantage over stand-alone firms in the pursuit of newly available equity resources. The signalling advantage is related to the economic prospects of a firm that intends to go public. In the run-up to an IPO, the firm must find a way to convey to investors the true value of its product, the feasibility of its business plan and its expected

630 MQ Agnoli and D Vilan, Financing trends in Latin America, (2008) 93 ECON REV 3.

631 SY Kang (2011) 112.

profitability. This is one of the factors that will determine the scope of investors' interest in a public share offering and the performance of the IPO.[632]

In developed countries, different types of intermediary can vouch for the firm before investors. For instance, when prominent venture capital funds invest in a firm, they signal to the market that 'the new venture is a "good bet" both at the time of IPO and in the future'.[633] This endorsement by VC funds has been tied to improved IPO performance.[634] A firm's association with reputable gatekeepers can also send a positive signal about the value of its products.[635]

However, these intermediaries are not always able to accomplish a similar function in emerging countries.[636] Instead, a firm's affiliation to a prominent business group can send a signal to investors about the firm's future prospects.[637] In this case, the ties between the firm and the group may resemble strategic alliances between newcomers and established firms.[638] Alliances of this nature allow the less established firm to

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632 R Gulati and MC Higgins, Which Ties Matter When? The Contingent Effects of Interorganizational Partnerships on IPO Success, (2003) 24 STRAT MAN J 24.

633 Id.

634 Id (pointing out the importance of ties with prominent VC funds when there is low demand for new equity issuances). See, however, PM Lee and others, The Contingent Value of Venture Capital Reputation, (2011) 9 STAT ORG 1 (clarifying that the impact of VC fund involvement depends on the growth stage at which the investment is made in the start-up).

635 R Gulati and MC Higgins (2003) (pointing out the value of ties with reputable gatekeepers when there is high demand for new IPOs); See also B Black and RJ Gilson, Venture capital and the structure of capital markets: Banks versus stock markets' (1998) 47 J FINAN ECON 243, 277. On how gatekeepers can reduce the information costs of investors see RJ Gilson and R Kraakman, The mechanisms of market efficiency, (1984) 70 VIRG L REV 4, 549-644.

636 In these jurisdictions, 'financial analysts, mutual funds, investment bankers, venture capitalists, and the financial press are not fully evolved'. T Khanna and K Palepu (2000) 868.

637 A similar situation arises when the group sets up a new firm. In this example, 'groups can use their track record and reputation in their established lines of business to gain credibility for new ventures among suppliers and customers'. Id.

638 For an analysis of this signalling advantage in the biotechnology industry, see R Gulati and MC Higgins (2003).

reassure investors as to its financial prospects and also help it overcome the 'liability of newness'.[639]

In the context of business groups in emerging countries, a group renowned for sound management may equally reassure the market concerning the new firm's profitability, a pledge reinforced by the firm's access to the group's financial and operational resources and, in some cases, to the group's reputation for fair dealing.[640] This signalling benefit can give group affiliates an advantage over stand-alone firms in the competition for equity funds in capital markets.

The incentives to engage in empire-building, the increasing availability of equity resources and the signalling advantage discussed above may lead the controlling shareholders of business groups to become repeat players in capital markets through the successive listing of affiliates, a pattern of behaviour seen across many Latin American countries.[641] In their capacity as repeat players in local capital markets, these controlling shareholders would have incentives to build up their reputational capital as required under the cost of capital model explained here.

D. Different bearers of reputation

As three models described above suggest, controlling shareholders may assume the role of reputational intermediaries for firms under their control. However, the

639 SJ Chiang, Venture Capital Financing, Strategic Alliances, and the Initial Public Offerings of Internet Startups, (2004) 19 J BUSS VENT 5, 724 ('By having strategic alliances with prominent partners, a start-up gains the benefit of these partners' reputations and thereby improves outside constituencies' perceptions of itself').

640 As explained further below, the controlling shareholders of corporate groups may be particularly mindful of their reputational capital.

641 See Chapter VI for anecdotal evidence of the prevalence of corporate groups in Latin American capital markets.

adeptness of controlling shareholders at playing this role is sensitive to their identity and the context in which they act.

For instance, families are effective bearers of reputation.[642] Close-knit families, a pervasive feature of developing nations, can be particularly interested in the success of their offspring and the preservation of their time-honoured traditions. When these families control a firm, they will seek to ensure the availability of transgenerational wealth through the preservation of control over successive generations.[643] Cultural inclinations might in some cases increase the propensity of families to hold on indefinitely to controlling stakes in local firms.[644]

The quest for transgenerational wealth is relevant to the reputation story because the succession process between founders and heirs extends the number of potential interactions between outside investors and the controlling family. Since the family hopes to retain majority ownership of the firm over consecutive generations, they will expect to be long-term repeat players in product and capital markets.[645] This gives them powerful incentives to build up a reputation for fair dealing.[646] Family control sends a signal to

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642 RJ Gilson (2007).

643 A Ellul (2009); RC Anderson and DM Reeb (2003) 1306; O Ehrhardt and E Nowak (2003); TG Habbershon and J Pistrui, 'Enterprising Families Domain: Family-influenced Groups in Pursuit of Transgenerational Wealth' (2002) 15 FAM BUS REV 223, 237; H Deangelo and L Deangelo (1985)

644 RJ Gilson (2007) 1673.

645 SY Kang (2011); RJ Gilson (2007)

646 Families may go to great lengths to protect their reputational capital. Family members who are not sound managers, who are seen behaving unfairly towards outsiders, or who otherwise become a liability for the firm may be swiftly cast aside. Examples include the recent fallout from a phone hacking scandal in the UK involving the Murdoch family (James Murdoch, the next in line for succession in the family's media empire, relinquished most of his responsibilities; see http://www.guardian.co.uk/media/2012/apr/03/james-murdoch-bskyb-live), the feud between Lilliane Bettencourt and her daughter Françoise for control over the family's assets, including a substantial stake in the French cosmetics company L'Oreal (the daughter sought to declare her mother mentally unfit and ultimately persuaded a court to place Lilliane under her guardianship; see http://www.bbc.co.uk/news/world-europe-15334991) and the management of Bavaria S.A.,

potential investors and trading partners about the value that insiders place on their own long-term reputation. This enhances the family's ability to commit credibly to fair dealing in the future.[647] This boosts the role of family groups as reputational intermediaries.

Highly visible entrepreneurs are also responsive to reputational incentives. There is evidence that individuals renowned for their business acumen pledge their reputational capital to ensure that newly formed or acquired firms will be properly managed.[648] Market participants are particularly alert to the activities of these prominent entrepreneurs. When one of these individuals takes over a firm there is usually an immediate price reaction that reflects the readjusted positive expectations of the acquired firm's investors and trading partners.[649] Highly visible entrepreneurs capture these benefits through their equity stake in the firm, which is one explanation for which they might have incentives to build up their reputations.[650]

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one of Latin America's largest beer companies (Julio Mario Santo Domingo, the head of the family controlling Bavaria S.A. forced his nephew Andrés Obregón to give up his position as CEO of the company in 2000, after only a brief stint at the company's helm; see http://www.semana.com/nacion/va-andres/15572-3.aspx).

647 RJ Gilson (2007) 1307.

648 This is similar to what happens when a venture capital fund invests in a start-up. Moreover, although investments by those prominent entrepreneurs known as 'business angels' can also have reputational benefits, the informal nature of angel financing often makes these benefits less tangible than those tied to investments by a venture capital fund. See D de Clercq and S Manigart, 'The Venture Capital Post-Investment Phase: Opening the Black Box of Involvement' in H Landstroom (ed) Handbook of Research on Venture Capital (Elgar Publishing 2007) 214.

649 A converse phenomenon could perhaps take place in firms that come under the control of known self-dealers, which may experience a loss of profits as its counterparties readjust the conditions under which they will deal with the firm in the future. See, for instance, Fraud Settlement Sapping TV Azteca Bond Demand, Bloomberg News (19 May 2011) available at http://tinyurl.com/7hja6qn.

650 The activities of Warren Buffet at Berkshire Hathaway are just one example of the prospective benefits tied to the reputational capital of prominent entrepreneurs. C Sutton, 'Berkshire Hathaway ranks number one in reputation', *CNN Money* (5 April 2010) and G Martin and J Puthenpurackal, 'Imitation is the Sincerest Form of Flattery: Warren Buffet and Berkshire Hathaway' Working Paper 2008 http://ssrn.com/abstract=806246.

The controlling shareholders of business groups can also be particularly sensitive to changes in their reputational capital.[651] This is due to the potential transmission of reputation between affiliated firms. Investors and trading partners will rationally rely on the actions of a controlling shareholder in one firm as a proxy for her behaviour in conducting the affairs of other firms within the same group. For this reason, the financial effects of reputation can spread across several firms under the control of a single shareholder. The transmission of the controller's reputation may reach listed firms within the group, as well as unlisted affiliates trading in local product markets, which could have a multiplying effect on the financial gains or losses described earlier. This places controlling shareholders in the position to act as reputational intermediaries for *all* the firms in the corporate group.[652]

A similar transmission effect may take place when the state holds a controlling stake in listed firms. Partial state ownership of listed firms is not unusual across developing countries.[653] Although there are many problems associated with state control over companies, the prospective role of governments as reputational intermediaries offers one potential advantage.

Governments might have financial incentives to develop a reputation for fair dealing towards outside shareholders, as seen in the privatization programs that some Latin American countries carried out over the past decade. Under these programs, local governments committed to gradually dispose of their equity stakes in local firms through

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651 RJ Gilson (2007).

652 'The pattern of family owned conglomerates in developing countries in part represents an effort to capitalize on scale and scope advantages with respect to an existing reputation'. RJ Gilson and C Milhaupt (2011).

653 M Pargendler, State ownership and corporate governance, (2011) SSRN Working Paper available at http://ssrn.com/abstract=1854452.

successive share offerings. In one illustrative case, the Uribe government in Colombia floated 10% of the country's largest oil company, Ecopetrol S.A., through an IPO in the local stock exchange. After this initial offering, the government announced that it would return to the market to sell another 10% of the firm's outstanding shares, an offering that is expected to take place before the end of 2013. The current Colombian government anticipates that it will continue with the gradual privatization of Ecopetrol S.A. into the near future.

In cases such as this one, when the firm under state control is expected to return to the stock market repeatedly after its IPO, governments are in a position to make use of the reputational mechanism explained in this Chapter. If a government builds up its reputation for treating investors fairly, it will be rewarded through the reduction of liquidity costs and non-diversification risks, and the reduction of the firm's cost of capital and its cost of doing business in product markets. These gains might be compounded if the government's reputation spreads to other state-owned companies undergoing gradual privatization processes. Political gains could also attach if voters saw fair dealing in the firm as a sign of honesty and competence or, as it happens frequently in Latin America, if voters themselves held equity stakes in partially privatized firms. With these incentives in place, a government could potentially act as a reputational intermediary in providing the assurances required by investors to overcome adverse selection.

There are, of course, numerous problems with the role of the government as a reputational intermediary.[654] The size and complexity of the state bureaucracy can lead to

[654] The fact that the government acts in this context as a shareholder and regulator has been singled out as a source of conflicts of interest. See M Pargendler (2011). It may not be easy to determine the extent to which the government's reputational concerns will deter it from taking actions that harm investors in state-owned companies.

coordination problems that render governments unable to send clear signals of fair dealing to investors or, worse still, that result in the reckless management of the firm's affairs. Moreover, governments may make decisions that reduce their reputation for fair dealing towards investors if they can obtain immediate political benefits by doing so. Examples include the appointment of incompetent individuals to the board of directors of a state-owned company in order to secure political alliances or the use of company funds to advance politically salient but unprofitable causes.[655]

Even if it were possible to overcome these problems, investors may still have no confidence in governmental assurances of fair dealing. Since new governments may replace the old government's policies (along with the officials that designed those policies), the end period for reputational intermediation is marked by future elections which—in most cases—are never too far away in the future. This last problem might particularly limit the ability of governments to commit credibly to investors concerning its future actions.

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655 Firms controlled by governments have traditionally been associated with 'state-sponsored incompetence and overmanning'. See State's Capitalism Global Reach, ECONOMIST (21 January 2012). To this effect, politicians may seek to favour family members by appointing them as managers of state-owned firms. In China, for instance, the now discredited political leader Bo Xilai may have had a hand in his brother's appointment, under a false identity and with a salary worth millions of US dollars, as executive director and deputy general manager of China Everbright Holdings, a large state-owned firm with interests that span several industries. See A Jacobs and M Wines, Murder Aside, China Inquiry Puts Couple's Wealth on Trial, New York Times (13 April 2012).

Chapter V

The interaction between formal and informal institutions

1. Maghribi merchants and New Julfan traders

The work of Avner Greif on eleventh-century Maghribi merchants has informed much of the current discussion on how informal institutions can sustain trade between commercial counterparties.[656] Greif identified the existence of coalitions in which informal relations of trust neutralized potential agency problems between these merchants. The central mechanism at work in the generation of trust was the reputation of Maghribi traders, which carried with it economic effects that created reciprocal expectations of fair dealing.[657]

The system worked on the idea that the reputation of merchants would have an impact on the costs of transacting business within the coalition.[658] When one of these individuals breached the community's shared norms, she would lose future trading opportunities with other members of the coalition.[659] As a result, 'the short-run gain from cheating was less than the long-run benefit an honest coalition member could obtain'.[660]

656 A Greif, Reputation and coalitions in medieval trade: Evidence on the Maghribi traders, (1989) 49 J Econ Hist 4, 857-882. See also A Greif, The fundamental problem of exchange: A research agenda in historical institutional analysis, (2000) 4 Europ Rev Econ Hist 251-284.

657 'The "trust" did not reflect a social control system or the internalization of norms of behavior (although these factors play a role in any economic system) […]. What enabled the traders to establish a gap between the lifetime expected income of an honest agent and a cheater was the fact that each coalition member benefited from a reduction in transaction costs'. A Greif (1989) 881.

658 S Aslanian, Social capital, 'trust' and the role of networks in Julfan trade: Informal and semi-formal institutions at work, (2006) 1 J Glob Hist 383.

659 Norms are important to the extent that they 'coordinate expectations and provide a shared understanding of the meaning of various actions'. A Greif, Coercion and exchange: How did markets evolve, (2008) 15.

660 A Greif (1989) 859.

This system of economic rewards and penalties allowed Maghribi merchants to commit credibly to fair dealing with other members of the coalition. The information about the behaviour of traders, which helped shape their reputations, was transmitted through commercial correspondence between coalition members. In this way, reputation-based trading within this network of individuals facilitated commercial exchange despite the absence of enforceable legal agreements.[661]

The previous paragraphs speak to several important traits of informal commercial exchange. For instance, relations of this nature may work best within a closed coalition of individuals with similar cultural backgrounds.[662] The trust inherent in this setting provides fertile ground for relational exchange between counterparties and, correspondingly, for reputation-based trading amongst the network of individuals.[663] The close-knit nature of a community also contributes to the dissemination of information through different means, including not only business relations but also family, religious and social ties.[664] The existence of multiple channels to share knowledge about the behaviour of individuals enhances the efficacy of the reputation mechanism.[665]

There is, however, one crucial element missing from this story. Since reputation-based trading ties past behaviour to future economic performance, the whole system rests on the prompt availability of indisputable information about the actions of individuals.[666]

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661 A Greif (1989).

662 RC Ellickson, Order Without Law: How Neighbors Settle Disputes (Harvard University Press 1991).

663 S Aslanian (2006).

664 RC Ellickson (1991).

665 S Aslanian (2006).

666 'Reputation, in turn, will only work to make promissory commitments credible if other contracting parties can conveniently learn about the reasons why any particular transaction broke down'. R

This information must allow third parties to judge unambiguously the manner in which a potential counterparty has conducted business in the past, so that a decision can be made as to whether or not she is trustworthy. The literature on private ordering and reputation in the context of informal trading in fact points to the importance of a mechanism for the production and diffusion of reliable information about the past behaviour of counterparties.[667] The mechanism discussed here should facilitate the 'full broadcast of information about wrongdoing' and provide 'some guarantee of objectivity'.[668]

To be sure, the inherent trust that exists between the members of a close-knit community can deal with this problem to a limited extent.[669] In the case of Maghribi traders, the close cultural ties between coalition members allowed them to rely on the accuracy of the information shared through their commercial correspondence. Nonetheless, the casual nature of these communications may have still left room for doubt concerning the allocation of blame in a trading dispute. If the dispute was complex, a simple report of misbehaviour may not have been unequivocal enough to damage the reputation of a trader. If the facts of the case were called into question, conflicting reports from each party may have sent ambivalent messages through the network, particularly if

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Scott, A theory of self-enforcing indefinite agreements, (2003) University of Virginia Law and Economics Research Paper No. 2. See also A Greif (1989) 868.

667 For a review of the extensive literature on the importance of information flows in the context of reputation, see WB MacLeod, Reputations, Relationships, and Contract Enforcement, (2007) XLV J ECON LIT 614-615.

668 RC Cooter, Normative Failure Theory of Law, (1997) 82 CORNELL L REV 947. In the context of diamond exchanges, the author suggests that internal merchant courts can foster cooperative behaviour between affiliated traders. 'When a merchant court finds that one member has cheated another, the wrongdoer may be excluded from the exchange and his picture may be posted in exchanges throughout the world. The merchant court's fact-finding process creates credibility, and posting the wrongdoer's picture facilitates a boycott' Id.

669 '[A] private-order institution might be able to support intra-community exchange relations even when conduct can not be legally verified'. A Greif (2008).

the parties were known rivals.[670] These problems set a limit to the effectiveness of reputational trading between Maghribi merchants.[671]

It follows that a centralized mechanism for the production of credible information about the past behaviour of counterparties and the rapid dissemination of this information can enhance the operation of reputation-based trading.[672] One example of a mechanism that may have performed this function can be found in the experiences of another group of pre-modern merchants, the New Julfan traders of Armenian descent, who operated over a vast territorial expanse during the seventeenth and eighteenth centuries.[673] These Julfan Armenian merchants formed part of a community that conducted long-distance trade through *commenda* contracts between its members. The agency relations born of these contracts and the lack of institutions for cross-border enforcement created the conditions for opportunism. Similar to the Maghribi community mentioned above, Julfan Armenian merchants relied mostly on a system of reputation-based trading to overcome this problem.

Information about the behaviour of coalition members circulated through a specialized courier network and by means of correspondence between dioceses of the Armenian Church. Those individuals known to deal unfairly with their counterparties quickly became outcasts, losing trading opportunities and social standing in the process. The cost of reputational damage was thought to exceed any potential gains from one-time

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670 'If the injurer and the denouncer are rivals, people may not believe the denunciation. In any case, overcoming the credibility problem depends on the neutrality of the speaker, or on the observability of the alleged facts'. RC Cooter (1997).

671 S Aslanian (2006).

672 When a group has an internal process 'for censoring or expelling members', this mechanism may 'improve credibility and broadcast denunciations more widely'. RC Cooter (1997).

673 S Aslanian (2006).

opportunistic behaviour, which granted credibility to the commitments of Julfan Armenian traders to deal fairly with other members of the community.[674]

However, in contrast to Maghribi merchants, the Julfans developed a centralized system for the production and dissemination of reliable information about the business practices of coalition members. Wherever a trading dispute arose between members of the community, an ad hoc court was assembled to settle the disagreement on the basis of a developing set of formal commercial laws. The written judgment and supporting documents produced by these courts were sent to the Assembly of Merchants, a sort of self-regulatory organization composed of prominent individuals within the community.[675]

The Assembly was the final authority for dispute resolution, often enforcing judgments against the defeated party's relatives. Crucially, it also acted as a 'centralized information clearing house' that documented the behaviour of merchants trading from Cádiz in modern-day Spain to Madras in Mughal India.[676] The members of the Assembly passed on this information to local merchants—often with the intention of shaming a known offender—from where it spread through the courier network and diocese correspondence.[677]

The existence of a centralized mechanism to produce credible information and disseminate it rapidly among traders greatly improved the effectiveness of the Julfan system of reputation-based trading.[678] The intervention of the Assembly of Merchants

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674 Id.

675 The ad-hoc courts sent these documents to the Assembly of Merchants 'if the defendant had already left town, or otherwise refused to pay his debt. S Aslanian (2006) 398.

676 Id.

677 Id. at 399.

678 'The ultimate weakness of the reputation-based informal institution model of trust, associated with the work of Avner Greif, is its inability to be exhaustive. For there to be higher levels of trust, and

increased the speed with which coalition traders learned about the behaviour of their fellow members, as well as the number of individuals that had access to the relevant data.[679] The application of an accepted set of commercial rules and the authority vested on the ad hoc courts and the Assembly also meant that the judgment of disputes between coalition members was final. After the Assembly had reviewed a case and decided to make its decision public, there was no ambiguity left concerning the actions of an uncooperative individual. The unequivocal information sent by the Assembly damaged the reputation of this individual, which triggered a response by the other members of the coalition.

In sum, the activities of the Assembly of Merchants produced credible information about the past behaviour of individuals and broadcast this information to coalition members, which enhanced the operation of informal exchange based on reputation between Julfan Armenian merchants.[680]

This Chapter looks at similar interactions in the context of modern capital markets. Whereas Julfan merchants operated in the complete absence of a state—which muddles the definitions of formal and informal institutions used here—the study of capital markets would be incomplete without the introduction of this element. As defined

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by extension cooperation between coalition members, a centralized merchant arbitrage institutions with some formal attributed needs to exist'. Id. at 393.

679 To be sure, the information about the behaviour of traders 'might not have been available to individual coalition merchants, with a more limited network of relations'. Id. at 400.

680 A similar relation between the application of rules and reputation-based trading may be found in the trading conducted by medieval merchants in Champagne Fairs, where the enforcement of the Law Merchant supported the operation of reputation-based informal exchange. See PR Milgrom and others, The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs, (1990) 2 ECON AND POL 1. See also L Bernstein, Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry, (1992) 21 J LEG STUD 115; L Bernstein, Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, (2001) 99 MICHIGAN L REV 1724.

in Chapters II and III, the formal institutions of capital markets derive their 'official' authority either directly (i.e. legal rules) or indirectly (i.e. self-regulation) from the state. These formal institutions can interact with the informal institution of reputational intermediation in many different ways.

Formal and informal institutions are often analysed in isolation, where one substitutes for the absence or inadequacies of the other. Traditional accounts of institutional development suggest that informal mechanisms are well suited to small economies with closely-knit groups of individuals, where relational exchange can take off.[681] Since it may be too costly for a nation to develop the infrastructure required to support the enforcement of explicit agreements (i.e. contracts or legal rules) in the short term, informal institutions provide a functional substitute for formal institutions. As a country develops, the contribution of informal mechanisms to the economy runs into an upper limit, at which point the formal institutions that support impersonal exchange become necessary to sustain further economic growth.[682]

The main objective of the analysis presented in this Chapter is to probe into the different stages of this transition, where formal and informal institutions can substitute or complement each other. For this purpose, the discussions here mix insights from New Institutional Economics with the theoretical and empirical findings of contract theory. This last element is crucial to understand the operation of formal and informal institutions

681 F Bickenbach and WH Liu, The role of personal relationships for doing business in the GPRD, China: Evidence from Hong Kong Electronic SMEs, (2010) Kiel Working Paper No. 1589.

682 RJ Gilson and C Milhaupt (2011).

in capital markets, as the relation between controlling shareholders and outside investors is essentially contractual in nature.[683]

Section 2 explores the existence of substitution effects between the institutions that support capital markets. Section 3 looks at micro-level complementarities in the relation between formal and informal institutions.

2. Institutional Substitution

Institutional theory has focused extensively on the presence of substitution effects between formal and informal institutions.[684] The starting point for this analysis goes back to Chapter II and the idea that different types of institutions can deal *independently* with the 'fundamental problem of exchange'.[685] The capital market institutions studied in the previous Chapters accomplish this goal by reducing the payoffs of insiders that behave opportunistically. When formal and informal institutions perform this function in capital markets, investors will have credible assurances that they will receive a fair return for their investment in a listed firm.

As explained in Chapter III, formal institutions supported by the state can provide these assurances by allowing investors to exercise certain rights or to seek redress before judicial authorities. Formal institutions may also be embedded in self-regulatory organizations with 'official' authority that promulgate and enforce their own rules.

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683 In fact, these investors may be seen as one party of an *equity contract* entered into with the company and its controlling parties for a portion of the firm's output. See JR Macey, The value of reputation in corporate finance and investment banking (and the related roles of regulation and market efficiency) (2010a) 22 J APP CORP FIN 4, 22; D Acemoglu and S Johnson, Unbundling institutions, (2003) NBER Working Paper No. 9934.

684 See, for instance, TR Zenger and others, Informal and formal organization in New Institutional Economics, (2001) Olin Business School Working Paper, available at http://apps.olin.wustl.edu/faculty/zenger/advances6u.pdf.

685 A Greif (2000).

Informal institutions can also supply the requisite assurances, as illustrated by the system of reputational intermediation discussed in Chapter IV. It follows that formal and informal institutions can act as functional substitutes to provide the assurances required by investors in listed firms.[686]

In some cases, however, the presence of one set of institutions may reduce the effectiveness of another set of institutions.[687] This 'crowding out' effect may take place, for instance, when the introduction of state-backed rules impairs the operation of informal institutions.[688] There is an extensive literature that studies the ways in which formal measures of contractual enforcement can undermine the effectiveness of informal exchange.[689] In the context of capital markets, a potential example of crowding out concerns the effect that the introduction of a federal system of securities regulation in the 1930's may have had on the operation of reputational intermediation by gatekeepers in the US.[690]

This Section examines the existence of substitution effects between the institutions that support capital markets. Before starting this analysis, it must be noted that institutions seldom provide complete substitutes for each other. For instance, the use of reputational mechanisms in emerging countries does not necessarily mean that formal institutions lack a role in sustaining market-based exchange. As explained later on, the

686 G Helmke and S Levitsky, Informal institutions and comparative politics: A research agenda, (2004) 2 PERSPECTIVES IN POLITICS 4, 725-740.

687 TR Zenger and others (2001).

688 S Lazzarini and others, Order with some law: Complementarity versus substitution of formal and informal arrangements, (2004) 20 J L Econ & Org 2.

689 See, for instance, RJ Gilson and others, Braiding: The interaction of formal and informal contracting in theory, practice and doctrine, (2010) 110 Colum L Rev 6.

690 Jonathan Macey, (2010a); Frank Partnoy, Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime, 79 Wash. Univ. L. Quart. 490 (2001).

behaviour of insiders in listed firms is assessed with reference to a set of formal legal rules that define what is understood by fair dealing, much like Julfan Armenians traders relied on a developing body of commercial law to evaluate the behaviour of coalition members.[691]

To arrive at a sufficiently nuanced picture of institutional substitution, this Section uses two points of reference. The first point of reference looks at the different *agents* that can provide the requisite assurances to investors, namely, the state, self-regulatory organizations (SROs) and private parties. Although these agents often intervene simultaneously in capital markets, the discussions below look at the actions of each agent in isolation. This clear-cut picture is then made more complex by an analysis of different agents operating jointly in the context of crowding out effects (Section 2.B) and complementarities (Section 3). The second point of reference takes into account the nature of the *institution* that these agents use for the provision of assurances to investors (i.e. officially-backed rules, reputational intermediation).

A. Substitution

Across modern industrialized nations, the state is thought to be the main agent in charge of providing the assurances required by investors in capital markets. The state can accomplish this goal through the use of formal institutions, which entails the design, promulgation and enforcement of legal rules that target tunnelling practices and regulate periodic disclosure. Using this setting as a default for expository purposes, substitution can occur whenever another *agent* (i.e. SROs, private parties) or a different *institution*

691 In the case of Maghribi traders, however, these standards of conduct were contained in communal norms, in what may be seen as a complete substitution by informal mechanisms of formal institutions. A Greif (1989).

(i.e. reputational intermediation) is in place as the main supplier of assurances to investors.[692]

Following the explanations made in Chapter IV, a potential example of institutional substitution in the context of capital markets may be found in the system of reputational intermediation that arguably operates in emerging countries. Institutional substitution comes about in this setting due to the deficiencies of the state apparatus, which render the formal legal system unable to deal with the opportunism of insiders in listed firms. This creates the space for non-state actors to intervene as the main agents in charge of supplying the assurances required by outside investors.

This description would fit the case of controlling shareholders that act as reputational intermediaries. Insiders who take on this role use an informal institution (i.e. reputational intermediation) to commit credibly to deal fairly with outside investors in a way that helps mitigate the adverse selection problem of stock markets in emerging countries.[693] In this example, substitution takes place along two dimensions: (i) Private parties assume the role of the state as the main *agent* that supplies the assurances required by investors and (ii) reputational intermediation replaces the legal system as the central *institution* through which the assurances are provided.[694]

A similar case of substitution could also be seen in the intervention of underwriters as reputational intermediaries for listed firms in US capital markets before

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692 The definition of substitution used here is adapted from TR Zenger and others (2001).

693 As explained in Chapter IV, the commitment is credible to the extent it is backed up by the intermediary's reputational capital, which may be depleted if this party strays from the expectations of investors.

694 In this context, the state and its system of legal rules could play a complementary role by enhancing the benchmarks against which the behaviour of insiders is assessed, as more fully described in Section 3 below.

the Great Depression.[695] The enforcement deficiencies of the US legal system at the time left outside investors vulnerable to the actions of insiders. The screening and monitoring role of the specialized brokers that underwrote NYSE share offerings was essential to provide some of the assurances that investors required to participate in an IPO. These underwriters pledged their reputational capital as collateral to back up their assurances to investors concerning the firms that raised equity through the NYSE. As in the previous example, private parties and a reputational mechanism substituted for the state and its system of legal rules.

In this same context, the activities of the NYSE provide another example of substitution. In its capacity as an SRO, the exchange was the agent in charge of providing the requisite assurances to investors in NYSE firms. However, it is not immediately clear whether the institution mainly used for the provision of assurances to investors was reputational intermediation or the system of official rules enacted by the NYSE. As explained in Chapter IV, the NYSE used its 'official' authority to promulgate internal rules and serve as a centralized body for their enforcement among NYSE firms. This may suggest that formal institutions were the main instrument used for the provision of assurances to investors. It is also possible, however, that these rules were simply supporting the exchange's reputational pledge to investors. According to this last view, reputational intermediation may have been the central instrument through which the assurances were provided. This discussion is revisited below.

In all of the examples mentioned above, substitution comes about in a setting in which the state is unable to provide the requisite assurances to potential investors in listed

[695] See Chapter IV.

firms.[696] However, substitution in capital markets can also take place against the backdrop of a strong state, as illustrated by the experience of the Alternative Investment Market (AIM) in the UK.[697] Through a deliberate policy choice, AIM adopted a system of extended reputational intermediation as a substitute for the state and the mandatory system of regulation for listed firms. As explained below, the mixed results of the AIM experiment provide important insights for the study of substitution in capital markets.

The London Stock Exchange (LSE) set up the AIM in 1995 as an experiment in low-cost regulation for listed firms.[698] The AIM segment did away with most of the listing qualification requirements (i.e. track records, minimum float) and ongoing obligations (i.e. quarterly reports, auditing committees, independent directors) that are common for publicly-held firms in the main lists of stock exchanges. This policy choice to soften listing obligations sought to reduce the fixed costs of seeking access to public equity, which set IPOs beyond the financial means of medium-sized firms. Rather than relying on mandatory securities regulation to govern the activities of AIM firms, the LSE designed a system of extended reputational intermediation through financial consultants known as Nominated Advisers or 'Nomads'.

Nomads were initially thought of as guides for firms that planned to go public on the AIM, a role that was not significantly different to that of investment banks and law firms. The key innovation here was the decision of the LSE to outsource the ongoing

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696 A good portion of the available literature on private ordering focuses on the use of reputation and similar mechanisms when 'reliable state-sponsored contract enforcement is unavailable'. For a review of this literature, see BD Richman, Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering, (2004) 104 COLUM L REV 2335-2336.

697 For examples of substitution of this nature in other contexts, see BD Richman (2004) and L Bernstein (1992).

698 For a detailed analysis of AIM's regulatory model, see JM Mendoza, "Securities regulation in low-tier listing venues: The rise of the Alternative Investment Market" (2008) 13 Fordham J Corp & Fin L 1.

oversight and regulation of AIM firms directly to Nomads. In fact, these specialized advisors act not only as private consultants, but also as gatekeepers and regulators of firms listed on this market segment. In their role as private consultants, Nomads liaise with institutional investors and the LSE in order to advice their client firms as to how to meet market expectations. As gatekeepers, Nomads use a suitability test to screen AIM applicants. Although the exchange provides guidelines for this test, Nomads have ample discretion when deciding whether or not to admit a firm for trading on the AIM. Finally, as ad hoc regulators, Nomads can discipline their clients or even recommend forced delistings to the LSE.

The policy choice to soften listing obligations does not mean that AIM firms are free from the influence of mandatory rules. The LSE kept several rules in place, such as the ones that govern insider trading (as required by the Market Abuse Directive), periodic reports to investors and the disclosure of relevant information and significant corporate transactions. Moreover, under the guidance of Nomads, listed firms usually adopt a voluntary set of disclosure and internal governance rules that match industry practices and market expectations. To this effect, Most AIM firms voluntarily abide by either the Combined Code on Corporate Governance or the Quoted Company Alliance's Corporate Governance Guidelines for AIM Companies.[699]

The case of AIM shows two potential substitutions of the kind described earlier. The first substitution relates to the agent that provides the assurances required by AIM investors. For firms on LSE's Official List, these assurances are mainly supplied by the state. AIM investors, who due to a policy choice cannot rely on the state to a similar

[699] JM Mendoza (2008).

extent, obtain their assurances directly from Nomads. The second substitution concerns the institution through which these assurances are furnished. As in the case of gatekeepers, Nomads pledge their reputational capital to investors in order to vouch for the future behaviour of their clients. This pledge is crystallized through the influence of Nomads on their clients, who are directed to act in accordance with market expectations.[700] Reputational intermediation therefore substitutes for the legal system of rules that governs firms listed on the UK's Official List.[701]

The results of the AIM experiment with institutional substitution have been mixed. One of the few empirical tests conducted on the performance of AIM firms found some limitations of the Nomad model in the UK context.[702] For instance, the study points at serious problems with the screening process conducted by Nomads for the admission of firms into AIM. To reach this conclusion, the authors draw a comparison between firms listed on AIM and firms whose shares are traded in unregulated over-the-counter (OTC) markets in the United States.[703]

In the US, OTC transactions are often carried out through electronic quotation venues such the 'Pink Sheets' system (referring to the colour of paper the quotations were printed on before the system became electronic).[704] This unregulated OTC market deals

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700 Similar to the example of the NYSE, AIM firms' voluntary adoption and abidance by these rules simply provide the means through which the reputational pledge is made effective.

701 For the UK's Listing Authority rules, see http://fsahandbook.info/FSA/html/handbook/LR. 'Nomads build their reputational capital by servicing clients over prolonged periods of time, and ultimately vouch for the suitability of AIM companies and the accuracy of their market disclosures'. JM Mendoza (2008) 318.

702 J Gerakos and others, Listing choices and self-regulation: The experience of the AIM, (2011) Chicago Booth Working Paper No. 04.

703 J Gerakos and others (2011).

704 BJ Bushee and C Leuz, Economic consequences of SEC disclosure regulation: Evidence from the OTC Bulletin Board, (2005) 39 J Acc & Econ 2.

mainly in low-grade securities issued by companies in economic distress or 'microcap' issues that fail to qualify for a regular listing in a stock exchange.[705] Many of the shares traded in these OTC markets are of such low value—penny stock, shares trading under $1 each, are common here—that they have attracted the attention of spammers and fraudsters bent on swindling the uninformed public.[706] Even so, the study cited above found that 'AIM firms are more like Pink Sheets firms than firms that trade on regulated exchanges and, if anything, underperform the typical Pink Sheets firm'.[707] This leads the authors to conclude that Nomads are not adequately screening new entrants to the AIM.

Another problem the study detected concerns the motivation behind the choice of Nomad. The ability of AIM firms to design most of their own rules gives rise to some heterogeneity concerning the regulation applicable to companies listed on this segment. This heterogeneity makes it difficult for AIM firms to differentiate themselves through the adoption of rules that stand out from the rest in order to signal 'good quality' to the market.[708] This opens up the possibility for firms to benefit from choosing high-profile Nomads, as the selection of an adviser with a strong reputation and ample experience may actually signal a listed firm's good quality to the market. After testing for this

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705 However, OTC markets may also quote liquid and highly valuable securities issued by foreign firms that cross-list into the US through an ADR program and do not want to incur the costs of accessing venues such as the NYSE or NASDAQ. N Bollen and W Christie, Market microstructure of the Pink Sheets, (2007) SSRN working paper, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=963460

706 L Frieder and J Zittrain, Spam works: Evidence from stock trouts and corresponding market activity, (2007) Harvard Public Law Working Paper No. 135.

707 J Gerakos and others (2011).

708 The flexibility to design disclosure and governance policies is what makes it difficult for firms to signal 'good quality' to the market. First, the design of rules that stand out among the whole pool of policies adopted by AIM firms is a costly endeavour that might generate substantial transaction costs. Second, even if such a rule were in place, the heterogeneity of disclosure and governance policies across AIM firms would create confusion amongst investors concerning the quality of such policies.

signalling effect, however, the study found that the choice of Nomad bore little or no relation to the post-IPO performance of AIM firms.[709]

The results of the AIM experiment in the UK reveal an important insight about the complexities of institutional analysis.[710] The potential of an institution to take on a certain role does not automatically mean that the institution will in practice perform the functions expected of it.[711] Institutional theorists warn about the pitfalls of 'functionalism', that is, the tendency to pay too much attention to the presumed attributes of institutions without regard for the overall context in which they operate and the underlying causes that explain their existence.[712]

There are numerous factors that can render institutions dysfunctional, even against the best efforts of policymakers.[713] Chapter III explained in detail how the weakness of

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709 J Gerakos and others (2011). The authors suggest that this may be due to 'limited reputational or other risk' for Nomads, which leads these advisors to converge on similar low levels of oversight across all AIM firms. However, a more recent study found that the reputation of Nomads had a 'significant impact on IPO survival' on the AIM. See S Espenlaub and others, IPO Survival in a Reputational Market, (2012) 39 J BUSS FIN ACC 3, 427.

710 The Japanese experience with a similar model has not been more successful than UK's AIM. After lagging behind JASDAQ for many years, the Tokyo Stock Exchange (TSE) announced plans to introduce a new venue designed to replicate the approach of London's Alternative Investment Market. Tokyo AIM specifically targets high-growth companies that can benefit from the venue's reduced listing costs. Since it grew out of a joint venture between the Tokyo and London Stock Exchanges, the new segment embraced an internal structure similar to that of the AIM. For instance, the new venue requires firms to retain the services of J-Nomads, special advisers that emulate the role played by Nomads on AIM. The flexible listing process and ongoing disclosure requirements also resemble London's low-tier market. Despite the media campaign launched simultaneously with Tokyo AIM, the new venue has only gained one listing since it was granted an operating license in 2009 (a new listing application was under review at the start of 2012). Interestingly, only 7 firms have registered to act as J-Nomads within the new segment. Although this might be due to a number of different factors (including a reduction of the appetite for the risk profile of small firms, brought about by the most recent financial crisis), the now apparent shortcomings of the AIM experiment may have had a hand in AIM Japan's failure to launch.

711 JE Stiglitz, 'Formal and informal institutions' in Social Capital: A Multifaceted Perspective, (P Dasgupta and I Serageldin, eds, The World Bank, 1991).

712 C Crouch, 'Complementarity' in The Oxford Handbook of Comparative Institutional Analysis (G Morgan and others, eds, OUP 2010).

713 JE Stiglitz (1991).

the state apparatus in emerging nations degrades the operation of formal legal rules. The failure to accommodate for these conditions suggests that the reform programme launched in these jurisdictions may have been informed by an overly functionalist approach.[714]

It is therefore important to proceed with caution when analysing alternative avenues for institutional reform. To be sure, the inability of the legal system to fully regulate the behaviour of insiders in listed firms does not mean that reputational intermediation will necessarily take over. Aside from macroeconomic factors such as industrial relations and ownership patterns, the actual performance of institutions turns heavily on the absence of obstacles that neutralize their effects as well as on the coexistence of other supportive institutions. The following sub-section explores how crowding out effects can act as a potential obstacle for the operation of institutions. The study of positive interactions, or complementarities, is taken up in Section 3.

B. Crowding out

Crowding out takes place whenever the state replaces SROs and private parties to become the principal agent for the provision of assurances to investors. Crowding out may also occurs when legal rules take the place of other mechanisms as the main instrument through which the assurances are furnished. The distinguishing trait of crowding out effects lies with the friction that the intervention of the state creates with regard to pre-existing institutions.[715] Under this view, the introduction of rules backed by

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714 This runs alongside the usual claim that the World Bank confused the form of institutions with their function.

715 Under crowding out, state-based formal institutions are 'damaging to the formation and operation of informal elements'. TR Zenger and others (2001)

the state degrades the operation of the institutions that previously sustained market-based exchange.[716] Two slightly different cases of crowding out effects are studied below.

Positive crowding out effects

A potential example of crowding out effects involves the regulatory regime built on the foundations of the Securities Act of 1933 and the Securities Exchange Act of 1934 in the US. The historical account of US capital markets presented in Chapter IV left off at a point in which the NYSE and investment bankers were the agents primarily in charge of reassuring investors as to the accuracy of disclosures and the behaviour of insiders in listed firms, through the mechanism of reputational intermediation. After a period of sustained growth, the US capital market crashed in 1929, marking the start of the economic crisis now known as the Great Depression. In the three years following the crash, the total value of NYSE shares went from $90 billion to $16 billion, while the failure of large businesses such as Samuel Insull's energy conglomerate generated massive losses for workers, shareholders and bondholders alike.[717]

Public opinion turned strongly against the institutions that had until then supported the operation of stock markets,[718] a development that explains the openly hostile attitude of politicians towards what they now saw as a 'wild orgy of

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[716] DC North, Institutions, Institutional Change and Economic Performance (Cambridge University Press 1990).

[717] RD Cudahy and WD Henderson, From Insull to Enron: Corporate (Re) Regulation after the Rise and Fall of Two Energy Icons, (2005) Indiana University Legal Studies Research Paper No. 18, 73.

[718] 'Following the Great Crash of 1929, blaming underwriters became politically popular, and therefore some form of underwriter liability seemed inevitable by the early 1930s' F Partnoy (2001).

speculation'.[719] The widespread calls for state intervention led the US Congress, after a series of hearings and under the aegis of President Roosevelt's New Deal, to pass a comprehensive set of rules meant to govern the activities of listed firms.[720] This new system of state-backed regulation targeted issuers, gatekeepers and SROs in an effort to address the causes that in the eyes of the public and policymakers had led to the stock market crash of 1929.

The Securities Act of 1933 introduced rules on the registration of new securities offerings, provisions governing initial disclosure statements and a system of enhanced civil and criminal liability.[721] Under the 1933 Act, issuers started facing absolute civil liability for material misstatements or omissions in their initial disclosure statement that resulted in damages to investors.[722] An issuer's directors and officers also started facing similar liability for inadequate disclosure, as did the investment banks that underwrote initial public offerings.[723] The 1934 Securities Exchange Act mandated periodic disclosures for listed firms, set out anti-fraud provisions, created registration requirements for securities exchanges and other SROs, and, crucially, set up the Securities and Exchange Commission as a centralized regulatory body for the design of technical rules and the administrative enforcement of securities laws.[724] This system of

719 RD Cudahy and WD Henderson (2005) 74.

720 JC Coffee (2001b).

721 JC Coffee, Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, (2003a) Columbia Law School Working Paper No. 237.

722 MB Fox, Civil Liability and Mandatory Disclosure, (2009) 109 Col L Rev 2, 241.

723 Id.

724 JC Coffee and HA Sale (2011).

federal regulation has developed to vast extents through legislative action, the regulatory intervention of the SEC and litigation before an increasingly active judiciary.[725]

The system built on the foundations of the 1933 and 1934 Acts may have crowded out the institutions that sustained the initial development of US capital markets. Recall that, until the enactment of these laws, the NYSE and private investment banks were largely responsible for sustaining market-based exchange through a system of reputational intermediation anchored to the exchange's official rules and the underwriters' business practices. Although many States had corporate statutes and 'blue sky laws' that could have also performed these functions, all these rules were often poorly crafted and under-enforced.[726] Starting in 1933, the transition to an effective state-centred system of legal rules displaced the old system through different channels.

One major change was brought about by the new rules for issuers, which altered the incentive structure of reputational intermediaries.[727] The economic incentives that these intermediaries had to build up their reputational capital were closely linked to fact that investors relied mainly on their intervention to ascertain the quality of a listed firm prior to 1933. The better the reputation of an intermediary, the more sizable the economic benefits that flowed to that intermediary. After the reforms, the credibility of an issuer's commitment to deal fairly with outside investors was primarily backed up by the state through the enforcement of securities regulation, including a system of civil and criminal

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725 See, inter alia, MB Fox (2009), RD Cudahy and WD Henderson (2005) and JC Coffee (2003a).

726 LA Bebchuk and A Hamdani, Federal Corporate Law: Lessons from History, (2006) 106 Col L Rev 1793-1839; BR Cheffins, 'Law as Bedrock: The Foundations of an Economy Dominated by Widely-held Public Companies' (2003) 23 OXFORD J LEGAL STUD 11; JC Coffee (2001b).

727 JR Macey (2010a).

liability for improper disclosure.[728] As the role of reputational intermediaries in providing these assurances changed from essential to supplementary in nature, the value added by their services—and their correlated incentives to build up their reputational capital—decreased accordingly.[729]

The new rules on gatekeeper liability had a similar effect on the incentives that investment banks had to invest in their reputation. Before these rules came into place, a reputational intermediary had ample space to distinguish itself from its competitors through the scope of its investment in reputational capital (i.e. consistent positive behaviour over a long period of time). The liability regime set up for gatekeepers may have reduced the value of these investments in reputation. In fact, new entrants to the market for reputational intermediaries could now pose as reliable gatekeepers not because of their past behaviour, but because the threat of civil and criminal liability gave credibility to their commitments to investors.[730]

Another source of crowding out effects may be found with regulatory licenses—entitlements created by the legal system—that force issuers to retain the services of gatekeepers for reasons other than to rent their reputations.[731] Some examples of regulatory licenses include mandatory certification by credit rating agencies, audit reports

728 'To the extent that the public relies on regulation rather than reputation and reputational intermediaries for protection, the incentives for companies to build and maintain their reputations are diminished'. JR Macey (2010b).

729 Id.

730 This is argument is developed in the context of law firms by JR Macey (2010b). Nevertheless, liability rules for investment banks can also work as an entry barrier for 'less reputable firms, which are more likely to be found liable and which, therefore, will find it costly to imitate the signals of higher quality investment banking firms'. F Partnoy (2001) 520. It must be noted, however, that these liability rules now form part of a system that is considered crucial to deter rogue intermediaries from imposing negative externalities on other gateekepers. See B Black (2001).

731 F Partnoy (2001).

by accounting firms, valuations by investment banks and fairness opinion by these same banks and by law firms.[732] The forced intervention of gatekeepers creates an artificial demand for their services, without always ensuring that these services will be favourable to investors.[733] This forceful reliance on gatekeepers may reduce their incentives to invest in reputational capital, particularly in oligopolistic markets where issuers can only contract with a very limited pool of gatekeepers.[734]

The transition to a state-centred system also had an impact on the role of the NYSE as a reputational intermediary. As mentioned earlier, before the passage of the securities laws, the exchange's assurances about the quality of its members were anchored to the NYSE's ability to design and enforce its own rules. The new system significantly reduced the NYSE's ability to adopt special rules that could set its members apart from firms listed in other venues. As the 1933 and 1934 Acts regulated the activities of all issuers and market participants regardless of their affiliation with the NYSE, the Acts created a minimum regulatory threshold for accessing the market that blotted out the comparative advantage previously held by NYSE firms.

Still, the exchange could have just increased its own listing standards above the new threshold in an effort to preserve its reputation as the home of the highest quality

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732 JC Coffee, Enhancing Investor Protection and the Regulation of Securities Markets, (2009) Columbia University Law Working Paper No. 348 (on the regulatory license granted to credit rating agencies); F Partnoy (2001).

733 JR Macey (2010b) 435 (discussing the case of credit rating agencies).

734 F Partnoy (2001) 520. Interestingly, the author points out that the entry barriers created by gatekeeper liability rules can create an investment bank oligopoly that opens up space for these firms to engage in 'reputation-depleting' behaviour. See also JR Macey (2010b) 431: 'While these sorts of firms [accounting firms, law firm and credit rating agencies] once depended on their reputations to attract and retain business, many such firms no longer need to do so. Instead, clients are *required* to use the services of particular firms, so reputation is no longer particularly important in customer and client decisions about which firm to deal with. As such, reputation is no longer an asset in which it is rational to invest heavily'.

firms. However, the SEC co-opted the NYSE's ability to follow this course, as the regulatory agency became the centralized forum for drawing up internal governance rules for listed firms.[735] To this effect, 'all trading venues are properly understood as mere conduits for the SEC, which coordinates the corporate governance regulations that ostensibly are promulgated under the exchanges' authority as self-regulatory organizations'.[736] The erosion of the signalling advantages tied to an NYSE listing reduced the exchange's ability to act as a reputational intermediary. Competitive pressures from other trading venues further impaired the NYSE's ability to enforce even the few special rules that could potentially distinguish its firms from those listed in other venues (i.e. one-share, one-vote), which may be seen as the final nail in the coffin of the NYSE's reputational demise.[737]

As a result of these changes, investors in the US now rely on the state and its system of legal rules as the main source of assurances about listed firms. Although reputational intermediation has been relegated to a supporting role in the US, this development does not mean that gatekeepers are unimportant in this jurisdiction. Even in the US, where conventional wisdom suggests that formal institutions are in their strongest from, the legal constraints on insiders 'can be described as a glass at best half-full'.[738]

However, the preceding analysis reveals an important feature about the incentives of modern gatekeepers in the US. To the extent their role as reputational intermediaries has been diluted, so has their ability to profit from building up their reputational capital.

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735 JR Macey (2010b).

736 Id. at 441.

737 Id. at 441-442.

738 V Atanasov, B Black and C Ciccotello (2011) (on the shortcomings of anti-tunnelling rules in the US). Gatekeepers can provide validation and certification services to fill in the gaps left by formal state-backed regulation. See JC Coffee (2003a).

This makes it more likely than before, if the circumstances prove right, for one-time instances of cheating to become more valuable than the costs of reputational damage. The upshot is that reputation will be, on its own, a suboptimal constraint on the behaviour of gatekeepers.[739]

The cracks in the reputational model—as applicable in the US—become apparent when one examines the many instances of gatekeeper failure that have taken place over the past 20 years.[740] During the 1990's, a perfect storm of regulatory changes and market developments led to an outbreak of corporate scandals that culminated with Enron's bankruptcy and the enactment of the Sarbanes-Oxley Act. A large part of the blame for these events has been assigned to the negligent or deliberate oversight of auditors, analysts and other gatekeepers. Although the causes for this collective failure are as numerous as they are complex, a couple of factors stand out.[741]

As regulation superseded reputation in shaping the incentives of gatekeepers, the threat of legal liability turned into the main deterrent for these parties. However, a number of judicial decisions and legislative reforms during the 1990's decreased the liability exposure of gatekeepers.[742] These developments, added to the reduced importance of reputation as a behavioural constraint, cleared the way for gatekeeper failure.[743] Moreover, the mixture of consulting services and auditing functions in accounting firms provided both the financial incentives for these gatekeepers to overlook

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[739] F Partnoy, Strict Liability for Gatekeepers: A Reply to Professor Coffee, (2004) University of San Diego Legal Studies Research Paper No. 05-21.

[740] JC Coffee, Understanding Enron: It's About the Gatekeepers, Stupid, Columbia Law School Working Paper No. 207 (2003b).

[741] For an in-depth analysis of gatekeeper failure, see JC Coffee (2003a) and JC Coffee (2003b).

[742] See JC Coffee (2003b) for a complete list of these developments.

[743] F Partnoy (2004).

their clients' corporate malfeasance and a 'low visibility' channel for these clients to pressure their auditors into acquiescence.[744] The growth of equity-based compensation for corporate insiders during this period multiplied the incentives for these individuals to pressure gatekeepers to overlook the manipulation of financial statements.[745]

These concurring factors were at the heart of corporate misdemeanour in Enron, Worldcom, Tyco and many other firms. In the words of a prominent scholar in this field, 'as legal exposure to liability declines and as benefits of acquiescence in the client's demands increase, gatekeeper failure should correspondingly increase, as it did in the 1990's'.[746] A slightly different chain of events—but with similar results and now involving credit rating agencies—might have contributed to the onset of the most recent financial crisis.[747]

Several lessons relevant for institutional analysis may be drawn from the US experience with regulatory reform. For instance, crowding out due to state intervention does not completely supress the operation of other formal and informal institutions. These previously dominant institutions may simply assume a secondary role in supporting market-based exchange. Nevertheless, it is essential to understand the ways in which the introduction of state-backed rules affects those institutions, to facilitate their smooth operation under the new system. Failure to do so might have adverse consequences, as illustrated by the US experience with the regulation of gatekeepers.

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[744] JC Coffee (2003b) 15. The author points out that 'firing the auditor is a costly step, inviting potential public embarrassment, public disclosure of the reasons for the auditor's dismissal or resignation, and potential SEC intervention'. However, when auditors also provide consulting services, the client 'can then easily terminate the auditor as a consultant in retaliation for the auditor's intransigence'. Id.

[745] JC Coffee (2003a) 7.

[746] JC Coffee (2003b) 28.

[747] JC Coffee (2009).

Equally important is the attention that must be paid to the way in which the new state-backed system performs its functions. The regulatory regime that took the place of reputational intermediation in the US did a good job of providing assurances to investors and therefore served as the basis for the development into maturity of this nation's capital markets. To this extent, one may label this case as a *positive* case of crowding out effects.

How might a less effective legal regime impact on other institutions and the overall operation of capital markets? It may seem evident that ineffective new rules will fail to crowd out pre-existing institutions. After all, if investors do not believe that they can obtain the requisite assurances from the state, they will continue to rely on reputational intermediaries for this purpose.[748] However, the introduction of ineffective rules may degrade the benchmarks used to assess the behaviour of insiders. Investors may even wrongly assume that the new system is effective in protecting their interests. These examples relate to what may be called *negative* crowding out effects, a topic discussed below in the specific context of reputational intermediation.

Negative crowding out effects

In capital markets, the introduction of a new body of legal rules can produce different outcomes with regard to a pre-existing system of reputational intermediation. Five potential scenarios are analysed here. The first two scenarios have a positive outlook:

[748] JR Macey (2010a).

(i) If the new legal system actually protects investors to a higher degree than reputational intermediation, the result may be a positive case of crowding out effects, similar to what happened in the US after 1933.

(ii) If the new system only improves the quality of the benchmarks used to assess the behaviour of insiders, the result may an institutional complementarity, a topic analysed in Section 3 below. In this case, the new system does not actually serve as a stand-alone substitute for reputational intermediation. [749]

The next three scenarios start from a more negative perspective:

(iii) If the new system clearly does not improve on the protection afforded to investors, the latter will continue to rely on reputational intermediation and other mechanisms.

(iv) If the new system reduces the quality of the benchmarks used to assess the behaviour of insiders, it will obstruct the operation of reputational intermediation.[750] This scenario, which describes a case of negative crowding out effects, calls for a more detailed explanation than the ones offered above.

The mechanism that allows reputational intermediation to work is the dissemination of information about the behaviour of insiders in listed firms. As explained earlier, the information must convey an indisputable fact about the actions of insiders if it is to influence the firm's counterparties. For this purpose, the behaviour of insiders can be measured against norms of good behaviour (as in the case of the Maghribi traders), SRO

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749 In this scenario, investors may correctly judge that the new measures are a better proxy for fair dealing by insiders than the old benchmarks. Firms that adhere to the new measures therefore stand to benefit when investors readjust the conditions under which they deal with the firm to reflect the firm's adherence to the new rules.

750 In this case, it seems implausible for the new rules to actually serve as a stand-alone substitute for informal institutions.

rules (as in the case of the NYSE) or even a system of legal rules (as in the case of Julfan merchants).

Of course, these norms and rules must embody actions that will in practice amount to fair dealing. If these benchmarks do not ensure fair dealing—or if they send mixed signals about the behaviour of insiders—reputational intermediation will be impaired. With this insight in mind, the theoretical and empirical findings of contract theory reveal a channel through which the introduction of formal legal rules can degrade the operation of reputational intermediation.

Contractual arrangements can sometimes impact negatively on informal exchange.[751] This occurs when the adoption of formal measures (i.e. written contracts and state enforcement) makes the actions of contracting counterparties less observable, that is, when these measures 'degrade the information about the nature of the counterparties and the nature of their interactions'.[752] The idea here is simply that formal measures can alter the behaviour of contracting parties through 'cognitive shifts' away from social norms and towards a strict compliance with legal rules.[753] When this happens, formal institutions crowd out informal institutions as a support for contractual relations.[754]

Formal measures may similarly crowd out reputational intermediation in the context of capital markets. This could happen when the introduction of a new corporate governance system replaces the benchmarks against which investors assessed the

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751 RJ Gilson and others (2010).

752 Id. The main developments in this field have exposed how formal institutions can produce *motivation crowding out effects* in the context of reciprocity and norm-based behaviour. TR Zenger and others (2001) 14.

753 RJ Gilson and others (2010) 1400. The authors point out that formal measures can reduce the space for reciprocity to take place.

754 TR Zenger and others (2001).

behaviour of insiders. The previous benchmarks could have been set out in norms of good business behaviour or even in a pre-existing system of corporate and commercial laws that was superseded by the new rules.

In the scenario considered here, the new benchmarks degrade the quality of the information about the behaviour of insiders in listed firms. In this case, the new rules make the actions of insiders less observable.[755] For instance, the introduction of a corporate governance code can lead controlling shareholders to focus on strict compliance with the new rules (i.e. appointing nominally independent directors, setting up board committees, etc) instead of following norms of good behaviour (i.e. facilitating board review of conflicted transactions).[756] The fifth and final scenario considers an extreme case of this hypothesis.

(v) If the new system only *ostensibly* improves the quality of the benchmarks used to assess the behaviour of insiders, the outcome may again be an obstruction of reputational intermediation.

In this scenario, the new rules are not a better benchmark than the old norms or rules for the purposes of assessing the behaviour of insiders. However, investors are misled into believing that the new rules are an improvement over the old system. This may happen when local and international support for the new system infuses it with credibility. In this case, the introduction of the new system may create a sort of placebo effect that drives investors to positively readjust the conditions under which they deal

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755 'Informal contracting is supported by mechanisms that operate to make observable actions that reveal both compliance and counterparty traits […] these mechanisms fail when those actions are obscured by a noisy environment'. RJ Gilson and others (2010).

756 It must also be noted that 'if everyone transmits the same signal, the signal does not convey any information about differences among people' RC Cooter (1997) 19.

with firms that adhere to the new system. Every firm—even those with insiders that intend to cheat investors—will therefore have incentives to adopt the new rules in order to capture these economic benefits.[757]

At this point, insiders may lose the incentives to build up their reputational capital through actual instances of fair dealing. As their behaviour is assessed with reference to the new system, insiders are free to behave as they please while investors focus on the firm's compliance with the new rules. In other words, the misbehaviour of insiders can be masked behind the cover of full compliance with the new rules.[758] This sequence of events can impair reputational intermediation, since reputation is no longer a constraint on the behaviour of insiders. This scenario leads to the counterintuitive conclusion that even ineffective systems of legal rules can sometimes impair the operation of informal institutions.

To unpack this admittedly convoluted argument, it is useful to consider the case of legal reform in Latin America. As a result of the World Bank's reform programme, countries in the region introduced new statutes that mandate director independence and audit committees, as well many other mainstream corporate governance rules. Codes of best practice usually followed these statutes, adding recommended steps for summoning the general assembly of shareholders, rules on electronic shareholder voting and all sorts of detailed proceedings for the operation of various corporate organs. These corporate

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757 The introduction of the new system can produce a brief spurt of growth during which stock market activity increases temporarily. Nevertheless, unless remedial steps are taken, this stage of increased activity will inevitably prove to be short-lived. The eventual realization by investors that the new system is not better than the old system will once again give rise to the adverse selection problem that the new rules were designed to overcome.

758 Investors may not even take notice of positive acts that fall outside the scope of the new rules.

governance measures for listed firms have largely superseded the system of norms and legal rules that previously operated in the region.

One could see here a 'cognitive shift' in favour of the new rules, which have probably become the benchmark against which the behaviour of corporate insiders is assessed. Nevertheless, these measures are not likely to restrict the ability of insiders to behave opportunistically. As discussed in Chapter III, this may be due to several reasons. Many of the new rules exceed the capabilities of the region's enforcement infrastructure, while others set out measures that are simply ill suited to deal with the problems that are relevant in Latin American countries.

However, investors may wrongly believe that the new rules increased the constraints on the behaviour of controlling shareholders. To this effect, the support of supranational organizations (i.e. World Bank, OECD) and local governments grants credibility to the new corporate governance measures as a tool to protect investors. Accordingly, the insiders of listed firms that follow these new measures can give investors the false impression that they are more protected than before, when in fact the opposite is probably true.[759]

Since investors are focused on the firm's compliance with the new rules, the observable actions of insiders will be geared exclusively towards this end. This frees controlling shareholders to engage in tunnelling and make inaccurate disclosures. For instance, some Latin American firms that adhere strictly to the new corporate governance rules and best practices do not comply with the most basic disclosure requirements

[759] When a firm follows the full range of corporate governance rules and best practices, insiders can signal a purely ostensible commitment to good behaviour. In fact, the adoption of these rules and best practices may not be tied to real commitments to deal fairly with investors. These misleading signals are similar to what JC Coffee calls 'precatory signals'. See JC Coffee (2001a).

concerning their ownership structures.[760] As explained in Chapter VI, it is a real challenge to obtain accurate information about the complete ownership structure of Latin American listed firms.[761] The result may seem paradoxical: Firms that hide the identity of their controlling shareholders score perfect marks in corporate governance surveys.

Finally, the introduction of the new system could potentially impair the ability of reputation to act as a constraint on the behaviour of controlling shareholders. For this to happen, the reputational capital of insiders would have to be based on their compliance with the new system of corporate governance. In this case, since adherence to the new system would not limit unfair dealings, the reputational capital of controlling shareholders would be based on an illusion. The upshot is that reputation would stop being an effective lever to control the behaviour of insiders.

3. Complementarities

The study of complementarities is a field in constant flux. The various definitions of complementarity that theorists have put forward are still being discussed, as are the different applications attributed to this concept.[762] The idea of complementarity, borrowed from standard price theory, was adapted to the theory of institutions in order to describe the process through which the presence or improvements to one feature of economic organization increase the returns from a related feature within the same

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760 Since investors believe that the new system actually ensures fair dealing, they will positively readjust the conditions under which they deal with firms that adhere strictly to the new rules and practices. As controlling shareholders will not bear significant costs by following the new system and there may be considerable financial rewards for doing so, every firm will swiftly transition to the new system.

761 See, for instance, M Santiago-Castro and CJ Brown (2007): ‘corporate data for LA businesses is challenging to obtain, particularly, information on the ownership structure of the firm’.

762 C Crouch (2010); C Crouch and others, Dialogue on Institutional Complementarity and Political Economy, (2005) 3 Socio-Econ Rev 359.

system.[763] This notion of complementarity has been used to examine intrafirm processes (i.e. the relation between the marketing of customized products and 'computer-controlled production processes'), the match between macroeconomic variables such as industrial organization and technological production, and the relation between subsystems in coordinated and liberal market economies in the Varieties of Capitalism literature.[764] The wide range of the research conducted in this field calls for some preliminary remarks concerning the relevance of complementarities to the study of formal and informal institutions in capital markets.

A. Framing the issue

Complementarities are generally associated with positive economic outcomes.[765] The idea behind this view is that there are positive effects tied to the match between

763 P Milgrom and J Roberts, Complementarities and Systems: Understanding Japanese Economic Organizations, (1994) 9 Estudios Economicos 3; P Milgrom and J Roberts, The Economics of Modern Manufacturing, Technology, Strategy and Organization, (1990) 80 AMER ECON REV 511.

764 P Hall and D Gingerich, Varieties of Capitalism and Institutional Complementarities in the Political Economy: An Empirical Analysis, (2009) 39 BRIT J POL SC 449; N Kang, Analysing 'System Change': The Role of Institutional Complementarity in Corporate Governance, (2006) ICCSR Research Paper No. 43; P Hall and D Soskice, 'An Introduction to Varieties of Capitalism' in Varieties of Capitalism: The Institutional Foundations of Comparative Advantage (P Hall and D Soskice, eds, OUP 2011). M Aoki, 'The Japanese Firm as a System of Attributes' in The Japanese Firm: Sources of Competitive Strength (M Aoki and R Dore, eds, OUP 1994).

765 P Hall (2005). Another line of thought frames the discussion of complementarity in the context of institutional reform (see P Hall, 'Institutional Complementarity: Causes and Effects' in C Crouch and others (2005). Under this view, the existence of complementarities gives rise to path dependence and lock-in effects that create resistance to institutional change (see LA Bebchuk and MJ Roe, A Theory of Path Dependence in Corporate Governance and Ownership, (1999) 52 STAN L REV 127). In this context, complementarities are important to understand the effectiveness of legal transplants, as the operation of an institution in a donor jurisdiction usually depends on its interaction with context-specific features that may be absent in recipient nations (see S Deakin and others, An End to Consensus? The Selective Impact of Corporate Law Reform on Financial Development, (2011) ECGI Law Working Paper No. 182). An institutional reform process that includes legal transplants and fails to take these interactions into account will most likely be ineffectual.

different features of a jurisdiction's political economy.[766] For instance, as explained in Chapter I, there is a close correspondence between relationship-based financial systems and the intervention of banks as the central providers of financial services to an economy. The complementarity between these factors is one of the elements that can lead to a comparative advantage in technological processes based on incremental innovation.[767] Another example may be found in the complementarity between network monitoring and industrial activities that rely on inter-personal relations, with mutually reinforcing effects between the two.[768]

The economic effects of complementarities arise from the interaction between discrete features of a jurisdiction such as the nature of its legal rules, the orientation of its financial system, prevailing ownership patterns, industrial structure, labour relations and educational techniques.[769] An important attribute of the complementary relation between these features is the potential improvement of a nation's aggregate economic performance.[770]

The complementarities between the features mentioned above can be bidirectional, as in the match between bank-based financial systems and industries tilted

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766 P Hall (2005); P Hall and D Soskice (2011).

767 P Hall and D Soskice (2001).

768 Id.

769 P Hall and D Soskice (2001).

770 P Hall (2005). The author also considers the possibility that complementarities can give rise to rents captured by particular groups of actors, without neccesarily improving economic performance.

towards manufacturing (see Chapter 1) or between coordinated systems of industrial relations and financial arrangements that favour patient capital.[771]

Complementarities can also span more complex webs of interactions between institutions, market practices and macroeconomic features.[772] In India, for instance, some authors have identified complementarities between the prevailing industrial structure (services and software), financing patterns (equity-based finance) and the legal rules that support external finance (investor protection rules).[773] Moreover, during the 1970s in Japan, the contingent monitoring of firms by banks was said to have a complementary relationship with the local system of lifetime employment and team-oriented production techniques.[774] Similar clusters of complementary features have been identified across many different jurisdictions.[775]

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771 P Hall and D Gingerich (2009). Financial systems that favour 'patient capital' tend to operate in tandem with 'coordinated systems of industrial relations, as [managers and unions] can take the long-term viability of the firm for granted'. See C Crouch (2010).

772 R Deeg, Complementarity and Institutional Change: How Useful a Concept?, (2005) Temple Working Paper No. 21.

773 J Armour and P Lele, Law, Finance and Politics: The Case of India, (2009) 43 L AND SOC REV 491.

774 M Höpner, What Connects Industrial Relations and Corporate Governance? Explaining Institutional Complementarity, (2005) 3 Socio-Econ Rev 331. This complementarity arose due to a specific pattern of co-evolution between Japanese institutions. After the Second World War, the managers of Japanese firms sought protection against hostile takeovers through the mechanism of setting up cross-holdings between groups of companies. This led to the practice of choosing managers from the firm's own hierarchy of employees, which created incentives for these employees to 'accumulate managerial skills'. However, the lack of outside discipline due to the absence of hostile takeovers, added to the practice of team-oriented work, gave rise to moral hazard problems. To counteract these problems, a contingent system of monitoring was developed, whereby a firm's main bank would assume control if the firm found itself in financial distress. This was one of the several factors that created incentives for managers and employees to collaborate on preserving the firm as a going concern, despite the moral hazard problem inherent in lifetime employment and team production. See M Aoki and others, 'Unintended Fit: Organizational Evolution and Government Design of Institutions in Japan' in The Role of Government in East Asian Economic Development, (OUP 1998).

775 M Aoki and G Jackson, Understanding an Emergent Diversity of Corporate Governance and Organizational Architecture: An Essentiality-Based Approach, (2008) Industrial and Corporate Change, 1-27.

Large-scale complementarities such as these are central to the field of research associated with the Varieties of Capitalism literature. This political economy theory looks at how different systems allow firms to solve coordination problems in the areas of industrial and inter-firm relations, corporate governance, financing, vocational training and education.[776] In liberal market economies these coordination problems are dealt with through the use of market strategies that rely, for instance, on arm's length relations, competition and monitoring based on price signals; coordinated market economies feature non-market arrangements based on relational contracting, collaborative relations and network monitoring.[777]

In each kind of system, complementarities between a nation's political economy features reinforce the particular orientation of its solution to coordination problems. For example, the patient capital of bank-based financial systems is compatible with concentrated ownership structures and with long-term employee and supplier relations, all of which are features of coordinated market economies.[778]

Aside from the role of complementarities in reinforcing particular approaches to coordination problems, these complementary relations are seen in the Varieties of Capitalism literature as one of the sources of comparative institutional advantage. The idea here is that the complementarity between political economy features favours firms

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776 P Hall and D Soskice (2001). A coordination problem in industrial relations arises, for instance, when firms must decide how to negotiate 'wages and working conditions with their labor force'. Another example of a coordination problem concerns the different conditions under which investors will be willing to provide funds to the firm and the nature of the assurances requested by these investors to finance the firm. Id.

777 Id. It is important to note that liberal market economies and coordinated market economies are simply heuristic categories. Many countries combine elements of both systems.

778 C Crouch (2005); P Hall and D Soskice (2001).

that specialize in certain kinds of productive activity.[779] In Germany, for instance, the match between the corporate rules on co-determination, ownership structures that prevent hostile takeovers, a financial system tilted towards bank-based finance and social democratic corporatism is thought to favour incremental innovation processes.[780] The complementarities between these factors 'encourage long employment tenures and the development of inter-firm and employee relations' that facilitate 'corporate strategies based on product differentiation rather than intense product competition'.[781] The opposite is true in liberal market economies such as the US, where there is more space for radical innovation due in part to the complementarity between corporate rules that focus on public disclosure of information and facilitate takeovers, dispersed ownership patterns, a market-based financial system, and high labour mobility.[782]

Although a considerable portion of the literature on complementarities examines the complex relations between macroeconomic subsystems in the manner described above, the analysis presented in this Chapter is much less ambitious in scope.[783] The discussion below applies the main findings of the research on complementarities to micro-level interactions between formal and informal institutions in the context of capital markets. This limited approach is based on the idea that looking at small-scale

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779 P Hall and D Soskice (2001) 37. 'Complementarity of institutional forms describes a configuration in which the viability of an institutional form is strongly or entirely conditioned by the existence of several other institutional forms, such that their conjunction offers greater resilience and better performance compared with an alternative configuration' R Boyer, 'Complementarity in Regulation Theory' in C Crouch and others (2005).

780 M Aoki and others, Corporate Governance in Japan: Institutional Change and Organizational Diversity (OUP 2007); N Kang (2006).

781 P Hall and D Soskice (2001) 40.

782 P Hall and D Soskice (2001). To this effect, German institutions 'reflect higher levels of non-market coordination', whereas American institutions are geared to allow markets to 'coordinate endeavors in both the financial and industrial relations systems'. Id at 19.

783 M Aoki (2007); P Hall and D Soskice (2001).

interactions can enhance our understanding of large-scale complementarities between economic subsystems.[784] The point is simply that breaking down macroeconomic relations into their basic components can provide some insights into the nature of complementarities as well as their relative contribution to overall economic performance across jurisdictions.[785]

To illustrate this point, it is useful to examine the relation between industrial structure, financing patterns and capital market institutions. Industries that are heavily reliant on external capital have a complementary relation with financial systems geared towards equity finance and institutions that facilitate the process through which firms raise equity. The micro-level analysis proposed here would look first at how this last function (i.e. raising equity) is accomplished. Recall that both formal and informal institutions can facilitate the participation of investors in capital markets. However, formal and informal institutions can interact with each other along different dimensions.

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784 A study conducted in the UK hinted at a complementary relationship between the free market system in this country and strong state intervention in certain areas of the economy to control interest groups that would otherwise act in a way that could cause economic harm to themselves and others. See C Crouch (2010). To arrive at the existence of a complementarity in this context, it is necessary to consider a large number of variables across different subsystems of the economy, which brings a high degree of complexity to the analysis. By contrast, the study of interactions between two or more institutions within a single economic subsystem reduces the number of relevant variables and can thereby produce a more clear-cut analysis of complementarities. For example, as explained in the main text, the formal legal rules designed to counteract tunnelling in the US and this country's system of reputational intermediation are insufficient, on their own, to completely prevent opportunism by corporate insiders (V Atanasov, B Black and C Ciccotello (2011)). Their joint operation can lead to a complementary relation if one takes the view that complementarities arise when two or more different institutions make up for each other's shortcomings. The restricted scope of this analysis facilitates the process of isolating the components of this relationship, which can in turn shed some light on the operation of individual institutions and the nature of their interaction.

785 Disentangling the complex relation between political economy subsystems is in fact considered to be an important step towards a better understanding of macroeconomic complementarities. See R Deeg (2005). To this effect, it is important to note that this micro-level analysis should be seen as a mere first step towards an integral analysis of macroeconomic complementarities.

According to one definition of complementarity, formal and informal institutions may compensate for each other's deficiencies.[786] Since even the most effective state cannot fully protect outside investors, the intervention of gatekeepers is seen as necessary to fill in the gaps left by the state-backed system.[787] At the same time, the intervention of gatekeepers is not sufficient, on its own, to provide the requisite assurance to investors, which justifies the intervention of the state in capital markets. Legal rules and reputational intermediation by gatekeepers may therefore be seen as two complementary parts of a system that seeks to facilitate equity investments through capital markets.

Under this view, institutions influence the financial system's ability to supply equity capital, which has an impact on industries that rely on external finance. In this example, the relevant effects flow from institutions to the financial system and finally to industries that rely on external capital. The growth of these industries might then feed back into an increased demand for a financial system that is more effective at channelling resources from the public to listed firms and from this point on to the improvement of the institutions that facilitate this process.[788]

This is, to be sure, an oversimplified view of the intricate relation between these three elements, presented here only to illustrate the complexity of complementarity analyses. In fact, as explained in Chapter 1, this relation might initially flow the other way, that is, the development of industries that require external finance can exert pressure on the financial system to support the provision of equity, which then leads to the

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786 According to this definition of complementarity, 'each institution can be defined in terms of what is lacked by the other in order to produce a defined whole'. C Crouch (2010).

787 V Atanasov, B Black and C Ciccotello (2011); JR Macey (2010b) 441-442.

788 This interaction has been called a 'rolling relationship' between law and markets. See C Milhaupt and K Pistor, Law & Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World (University of Chicago Press, 2008).

improvement of the institutions that support capital markets.[789] The main point here is that, regardless of which way this relation flows, the financial system acts as a bridge in the connection between institutions and industrial structure.

Consider now a slightly different example under which the micro-level interaction between formal and informal institutions is complementary in a strictly economic sense. This means simply that the presence of one institution enhances the operation of the other.[790] For instance, as explained more thoroughly below, the action of the state can improve the effectiveness of reputation as a constraint on the behaviour of insiders through centralised naming and shaming and other informal enforcement techniques. In this case, the state not only protects investors through the design and enforcement of legal rules but also has a hand in the operation of reputational intermediation.

As opposed to the previous example—where the financial system linked institutions to industrial structure—there is now a direct link between institutions and industrial structure. Industries dominated by family firms or business groups are highly sensitive to reputational pressures of the kind exerted by informal enforcement techniques. The intervention of the state to facilitate equity investments may therefore be more effective in these industries than in those where families or conglomerates are not dominant.

The previous explanation suggests that the nature of the relation between formal and informal institutions can have an impact on macroeconomic complementarities. Whereas in the first example (where formal and informal institutions compensated for

[789] Once other factors such as education, labour policies and inter-firm relations are thrown into the mix, the complexity of this analysis would increase by an order of magnitude.

[790] C Crouch (2010).

each other's deficiencies) the financial system was the main link between institutions and industrial structure, the second example (where formal institutions enhanced the operation of informal institutions) shows that there may also be a direct link between institutions and industrial structure. It follows that the analysis of micro-level interactions between institutions might improve our understanding of large-scale complementarities between economic subsystems.

Aside from its analytical value, the study of these micro-level interactions may also have implications for policymakers in emerging countries. While macroeconomic complementarities cannot be deliberately produced through policy intervention, the same may not be true for micro-level complementarities.[791] Macroeconomic complementarities are often the result of institutional coevolution over time, a process of such complexity that it is almost impossible to anticipate its full effects ex ante.[792] In contrast to the interaction between entire economic subsystems, the relation between formal and informal institutions is comparatively simpler in nature. This makes it easier to understand the process through which complementarities arise in this limited setting, which could create the space for the process to be replicated deliberately.

B. Complementarities between capital market institutions

Despite the limited scope of the analysis presented here, there are multiple complementarities that may arise between capital market institutions. The main focus of

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791 C Crouch (2010); N Kang (2006) ('institutional complementarities do not arise from conscious design') 5.

792 See, for instance, M Aoki and others (1998) on the 'unintended fit' between complementary institutions in Japan. In this macroeconomic context, 'different institutions are brought together not because they remedy deficiencies in each other or because they embody some kind of similarity or affinity but because when they occur together they produce a stable model that is mutually reinforcing'. C Crouch (2010).

this subsection will be on relations that fit the concept of complementarity in a strictly economic sense, that is, where the presence or improvements to one institution enhance the operation of another institution.[793]

The complementarities studied here are based on the idea that informal exchange can be particularly sensitive to the pressure exerted by the operation of formal institutions.[794] Complementarities may therefore arise when this pressure enhances the performance of an informal institution. As expressed by North, formal institutions can 'complement and increase the effectiveness of informal constraints. They may lower information, monitoring, and enforcement costs and hence make informal constraints possible solutions to more complex exchange'.[795]

An example of the positive impact that formal institutions can have over informal constraints concerns the introduction of commercial rules that provide content to social norms of good business behaviour. Norms that have been assimilated by the members of a society can act as a constraint on the inclination of contractual counterparties to cheat each other.[796] If an individual considers that certain acts run counter to the rules that privately influence her behaviour or against which society measures her conduct, she will probably refrain from performing those acts.

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793 Under this view, 'institutional complementarity requires enhanced performance'. R Deeg, (2005). See also C Crouch (2010) and M Aoki and others (1998) for a discussion on the different definitions of complementarity. Although this process of institutional reinforcement may take place between capital market institutions of equal character (i.e. formal and formal), the discussions here look at interactions between institutions of dissimilar nature (i.e. formal and informal).

794 T Zenger and others (2001) ('Formal institutions influence the trajectory of informal institutions'). The authors suggest that the best way of modifying informal institutions is by means of the pressure exerted through the gradual adjustment of formal institutions.

795 DC North (1990) 46-47.

796 See RC Ellickson (1991).

One problem with norms as a constraint on the behaviour of contractual counterparties is that social conventions may not be clearly defined to reflect what must be understood as bad business behaviour. For this purpose, legal rules designed to prevent abusive behaviour in contractual settings—even those rules that are not properly enforced—can imprint norms with the idea that certain conducts are inadmissible. Although many other factors may shape the content and impact of social norms (social cohesion, religious affiliation, cultural mores, etc.), the enactment of legal rules that embody patterns of good business behaviour can have a direct effect on the operation of this informal constraint.[797]

With the previous considerations in mind, it is possible to identify a first case in which formal institutions can enhance the operation of reputational intermediation, the main informal institution studied in this dissertation. As explained earlier, rules enacted by the state or an SRO can supply the benchmarks required for reputational intermediation to work. For this informal institution to be an effective constraint on insiders, these rules must allow the firm's counterparties to distinguish between actual instances of fair and unfair dealing by corporate insiders.[798]

When formal rules take on this function, the firm's investors and trading partners will react to observed misbehaviour (i.e. breaching a rule) by negatively readjusting the

797 An interesting example of the influence that formal institutions can have over informal institutions concerns the enactment of rules that facilitate the execution of long-term contracts. These rules can expand the space for parties to develop informal relations of trust based on reciprocity and compliance over time. T Zenger and others (2001).

798 If the rules do not embody actions that lead to fair dealing, the reputational mechanism will be impaired. As expressed by RJ Gilson and C Milhaupt (2011), 'in order for the anticipation of future trading parties' actions to influence a trader's current behavior there must be a shared understanding of what constitutes breach of performance, and the trader's current behavior must be observable to potential future counterparties' (Economically Benevolent Dictators: Lessons for Developing Democracies, (2011) 59 AMER J COMP L 1).

conditions under which they deal with the firm in the future.[799] The financial penalty that this readjustment imposes on the firm can reach insiders through different channels, including their large equity stakes in the case of controlling shareholders or an increased vulnerability to hostile takeovers (due to a reduction of the firm's market value) in firms with dispersed ownership. The financial incentives to comply with the rules set out by the state or an SRO place a clear limit on an insider's ability to deal unfairly with investors.[800] For this reason, rules that properly define the contours of fair and unfair dealing can enhance the effect of reputation as a constraint on the behaviour of insiders.[801]

Rules can also add credibility to the assurances supplied by reputational intermediaries. For instance, as explained earlier, the listing rules set out by the NYSE before 1933 granted a measure of credibility to the exchange's commitment to investors concerning the quality of NYSE firms. These rules—which fall within the classification of formal institutions used here—supported the exchange's role as a reputational intermediary.

Another potential complementarity between formal and informal institutions involves the use of informal enforcement techniques.[802] While formal enforcement is

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799 J Armour, C Mayer and A Polo (2010); JM Karpoff (2008); B Liebman and C Milhaupt (2008).

800 There is a growing body of evidence to support the existence of financial penalties tied to reputation. Studies have measured this cost in the negative price shocks suffered by companies that engage in fraudulent or otherwise reprehensible activities that harm the firm's customers or investors. See J Armour, C Mayer and A Polo (2010) and JM Karpoff, DS Lee and GS Martin (2008).

801 The literature produced in this field over the past 20 years is extensive. For discussions on reputational penalties, see J Armour, C Mayer and A Polo (2010); JK Tanimura and MG Okamoto (2010); B Black (2009); J Armour and others (2009); JM Karpoff, DS Lee and GS Martin, (2008); CR Alexander (1999) and JM Karpoff and JR Lott (1993).

802 For an analysis of informal enforcement, see J Armour and others, (2009); J Armour, (2008). See also RE Scott and PB Stephan, The Limits of Leviathan: Contract Theory and the Enforcement of

based on litigation between a firm's constituencies or the imposition of fines for breaching mandatory rules, informal enforcement relies on the financial cost of reputational loss.[803]

Informal enforcement involves an agency with official authority that is charged with producing and disseminating information about the behaviour of insiders in listed firms.[804] When improper behaviour is detected in a firm, as measured against a system of formal rules, this agency reacts with a public admonition through 'oral warnings, letters of oversight and supervision, notices of criticism and public criticisms'.[805] This strategy of naming and shaming moves the firm's counterparties to negatively readjust the conditions under which they deal with the firm. Since the financial cost tied to this readjustment affects corporate insiders, these parties will have incentives to behave in a way that will not trigger naming and shaming sanctions.[806]

The importance of informal enforcement lies with the dissemination of reliable information about the behaviour of corporate insiders.[807] The authority vested on the agency in charge of naming and shaming means that any sanctions indisputably signal

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International Contract Law, (CUP 2006) 23: ('Formal enforcement can complement and support informal enforcement when it is deployed as a supplement rather than as a replacement').

803 J van Erp, 'Reputational Sanctions in Privaste and Public Regulation' (2008) 1 ERASMUS L REV 145, 162; J Armour (2008) 4.

804 J Armour (2008).

805 B Liebman and C Milhaupt (2008).

806 Although informal enforcement is used in several jurisdictions, perhaps the most successful example of its implementation can be found in the UK. Listed firms that fail to comply with the rules enacted in this jurisdiction can face a barrage of informal actions at the hands of the Financial Services Authority. Since the loss of reputation can generate significant financial costs for firms listed in the UK, informal enforcement is an effective constraint for the behaviour of corporate insiders in this jurisdiction. See J Armour, C Mayer and A Polo (2010); J Armour and others (2009); J Armour (2008). Similar enforcement strategies are also used with varying degrees of success in China and Japan. B Liebman and C Milhaupt (2008) (for China); JK Tanimura and MG Okamoto (2010) (for Japan).

807 J Armour (2008)

unfair dealings of some sort. This authority also allows a firm's counterparties to trust the information conveyed by the agency. In addition, informal enforcement centralizes the production of information about the actions of insiders.[808] Absent this centralized mechanism, the firm's counterparties would have to judge the behaviour of insiders based on individual—and potentially conflicting—interpretations of publicly available information.

Informal enforcement therefore facilitates the readjustment of the conditions under which the firm's counterparties deal with it in product and capital markets, the mechanism that drives reputational intermediation.[809] In this way, the intervention of the state or another official authority may improve the effectiveness of reputation as a constraint on the behaviour of insiders. In other words, a formal institution (i.e. the rules that are used for informal enforcement) can enhance the operation of an informal institution (i.e. reputational intermediation).[810]

Reputational damages inflicted by informal enforcement can harm the relationship of firms with banks and prospective partners for future projects.[811] 'Naming and shaming' actions might even draw the attention of local media outlets, which would amplify the

[808] This signalling function is similar to the one provided by fraud enforcement actions in the US. In this case,'the [US] government's securities fraud enforcement efforts can improve the efficacy of regulation by helping market participants to distinguish situations in which bad outcomes are nobody's fault from cases in which bad outcomes reflect the failure of a reputational intermediary. J Macey (2010a).

[809] It may also be possible to create additional penalties of a regulatory nature that supplemented reputational penalties (i.e. limits to equity issuances, mergers and bank finance) B Liebman and C Milhaupt (2008).

[810] Reputational penalties tend to be more effective when channelled through 'an objective and expert agency which investigates conduct and publicises results'. J Armour (2008).

[811] Id.

reputational damage to non-cooperative types.[812] If one adds up all these costs, informal enforcement could potentially inflict large financial penalties on insiders that expropriate outside investors.[813]

Informal enforcement strategies have great potential in developing nations, an idea explored more thoroughly in Chapter VI.[814] Naming and shaming can be particularly useful in these jurisdictions due to the weakness of the state apparatus and the prevalence of family business groups with visible insiders.[815] Adopting a strategy of informal enforcement may also be a relatively cheaper option to control the behaviour of insiders than a reform of the framework that supports formal enforcement.

However, even if informal enforcement is thrown into the mix, there is an upper bound to the contribution of informal institutions to the development of capital markets.[816] For the reasons explained in Chapter VI, relational exchange limits the total number of potential interactions in capital markets and does little to assist standalone firms that seek to raise equity. It follows that the development of the framework required to support impersonal exchange must remain a priority of policymakers in emerging countries. The following Chapter examines transitional strategies designed to pursue the

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812 On the importance of the media as a constraint on private benefit extraction, see A Dyck, N Volchkova and L Zingales, 'The Corporate Governance Role of the Media: Evidence from Russia' (2006) 63 J FIN 1093, 1135.

813 B Liebman and C Milhaupt (2008) 967.

814 'In settings where hazards are severe, the combination of formal and informal safeguards may deliver greater functionality than either institutional type in isolation'. TR Zenger and others (2001).

815 DA Skeel, 'Corporate Shaming Revisited: An Essay for Bill Klein' (2005) 2 Berkeley BUS L J 105, 117; T Nenova (2005) 220. See also B Liebman and C Milhaupt (2008) 932.

816 RJ Gilson and C Milhaupt (2011). According to TR Zenger and others (2001), 'the benefit of formal institutions becomes relatively more important in new or non-recurring relationships, since informal enforcement will tend to be weak or absent'.

dual goal of enhancing the operation of informal mechanisms while at the same time gradually building up the institutional capacity to support impersonal exchange.

Chapter VI

Transitional Strategies for Institutional Reform

1. Latin American stories

Two bills made their way to the Congress of the Republic of Colombia, the country with the fastest-growing stock market in Latin America.[817] The first bill expressly addressed the regulation of listed firms.[818] Aside from granting the government wide-ranging powers to regulate capital markets, the bill included mainstream corporate governance provisions such as rules on precatory proposals to the board, a requirement for boards to have audit committees and a minimum number of independent directors, the need for officers to certify financial statements and the obligation to set up internal controls systems similar to those regulated under Section 404 of the Sarbanes-Oxley Act in the United States. After swift passage through the Colombian Congress, where few objections were raised, the bill was enacted as Law 964 in July 2005. Law 964 is the cornerstone of Colombia's system of capital market regulation, as well as the main reason this small emerging country is ranked by the Doing Business programme amongst the top five nations in the world under the category of investor protection.[819]

The second bill, filed for Congressional approval in 2011, introduced minor reforms to the country's general company law regime. Amongst its many provisions, the

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[817] See N Mapstone, Colombia: Latin America's Equity Issue Superstar, Financial Times (16 January 2012).

[818] CI Rojas and A Gonzales, Mercado de Capitales en Colombia: Diagnóstico y Perspectivas de su Marco Regulatorio, (2008) ANIF.

[819] See rankings at www.doingbusiness.org

bill called for the creation of a registry to record the ownership structure of local firms up to the last real beneficiary.[820] The registry sought to facilitate the process of identifying the controlling shareholders of all companies with operations in the country. This measure targeted the use of special purpose vehicles to engage in self-dealing and tax evasion, a practice considered to be widespread in Colombia.[821] A short time after the bill was introduced, local interest groups coalesced against the creation of the registry, harshly criticising the government for what they denounced as an obstacle to foreign investment.[822] The Colombian Congress promptly dropped the rules concerning the registry.

The story of these bills underlines two issues that are central to understanding how reform can shape development patterns in Latin American capital markets. The first issue concerns the nature of institutional reform. Over the last decade, new rules for listed firms were enacted in countries across the region in accordance with the principles and recommendations of the OECD and the World Bank. This top-down reform programme sought to enhance the formal institutions that support capital markets through the introduction of corporate governance rules mostly taken from developed nations, as in the case of Colombian Law 964 of 2005. As explained further below, the mixed results of this programme raise a number of questions concerning institutional reform in Latin America.

820 The information filed with the registry would be strictly confidential except for its use during administrative investigations by governmental agencies.

821 Although this duty to disclose beneficial ownership was to be imposed only on closely-held companies, it had the potential to affect firms listed in the local stock exchange that form part of corporate groups with public and private subsidiaries operating in Colombia.

822 Por qué están bravos? SEMANA (25 February 2012).

The second issue involves a political economy problem that has already been mentioned in the preceding Chapters.[823] Local institutional arrangements can produce significant benefits for a set of actors within an economy.[824] In Latin America, for instance, business groups controlled by a few dominant families benefit from institutional configurations that allow them to accumulate wealth and exert social and political influence.[825] These groups can easily coordinate their actions in order to block any changes to the institutions from which they obtain these benefits, regardless of whether reform would also enhance overall welfare.[826] As stated earlier, this resistance to institutional reform can manifest itself through the open obstruction of legislative initiatives or by subtler tactics such as the promotion or acceptance of ineffective rules.[827]

The nature of institutional reform and the resistance of interest groups to institutional changes are intricately related in the analysis of emerging capital markets. The previous Chapters suggested that regulating the behaviour of controlling shareholders in listed firms could contribute to stock market growth. One way of dealing with these insiders is to introduce measures that enhance the operation of formal and informal institutions. However, since controlling shareholders benefit from incumbent

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823 'Reforms that, by stimulating growth, will increase the size of the overall pie are blocked by groups who, economically successful and therefore politically influential under the existing regime, believe that their positions will be threatened by the growth-inducing reforms'. RJ Gilson, H Hansmann and M Pargendler (2010).

824 As explained further below, these arrangements can also form part of macroeconomic complementarities that redound to the benefit of overall economic performance. For instance, the institutional configuration that facilitates the operation of corporate groups allows these organizations to deal with shortcomings in labour, product and financial markets. In some cases, corporate groups can form part of a Big Push in a way that enhances aggregate economic performance.

825 T Khanna and Y Yafeh (2007).

826 BR Cheffins (2003).

827 M Ventoruzzo, 'Takeover Regulation as a Wolf in Sheep's Clothing: Taking Armour & Skeel's Thesis to Continental Europe', Penn State Legal Studies Research Paper 2008 http://ssrn.com/abstract=1084429.

institutional configurations, they will vigorously oppose any reforms that could leave them worse off. Examples of this pattern of behaviour may be found in almost every country in the region, from the doomed registry bill in Colombia to the latest attempts to reform the rules that govern firms listed in Brazil's Novo Mercado.[828]

With this insight in mind, it may seem puzzling that local interest groups did not significantly oppose the introduction of legal reforms in Latin America as part of the corporate governance initiative launched there during the last decade. Aside from raising operational costs for listed firms, these reforms were specifically designed to reduce the private benefits of corporate insiders in order to promote the development of capital markets. To be sure, interest groups may have expected to reap offsetting benefits tied to reductions in the cost of capital and a higher degree of investment in capital markets, which could explain their lack of opposition. In addition, the intervention of supranational organizations could have helped to neutralize any opposition from interest groups that did not benefit from the reforms.

There are many reasons to believe that this, however, was not the case. For instance, if the new rules had accomplished their objective of constraining self-dealing, they would have eroded the significant advantages of business groups in the sphere of labour, product and financial markets. At the same time, outside investors would have captured a portion of the benefits generated by the cost of capital reductions tied to the reform. The high costs imposed on corporate insiders by the new rules, added to the need to share any resulting benefits with outside investors, should have led at the very least to a mobilization of interest groups against the reforms. However, as mentioned above,

[828] M Avila and Y Yokoi, The Opportunity That Got Away, (2010) 8 CAPITAL ABERTO 86.

available records show no evidence of significant coordinated efforts to resist the introduction of the new rules.

A more negative reading of the apathy displayed by interest groups leads to the conclusion that the legal reforms introduced in Latin America may have been ineffective to constrain the behaviour of controlling shareholders. The argument here is that the reform programme was flawed, a fact that would have been noticeable—at least to corporate insiders—at the time the rules were being discussed in each country.

The specific rules proposed by the reform programme form part of a complex system of relations between market participants (i.e. institutional investors, managers, directors, different types of gatekeepers, market analysts, demutualized stock exchanges and other SROs, federal or national regulators, etc.) and interactions between discrete elements of economic subsystems in developed nations (i.e. labour mobility, industrial structure, ownership patterns, etc.). Extricating a few legal provisions from this environment and introducing them in emerging countries fully dilutes the effect originally intended for these rules and may have unintended consequences in recipient nations.[829] This approach to reform may create the false illusion of institutional improvement without actually doing much to solve the problems that ail capital markets in Latin America.

Although the evidence against the legal reform programme has been piling up, there have been few attempts to correct the course in Latin America. In fact, countries in the region are still being measured against the corporate governance standards set by the

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829 This idea has been developed extensively by the literature on legal transplants. See, for instance, A Watson, Legal transplants: An approach to comparative law (University of Georgia Press, 1993) and D Berkowitz, K Pistor and JF Richard, 'The transplant effect' (2003) 51 AM J COMP L 1, 163-203.

OECD, as evidenced by the ongoing World Bank's Reports on the Observance of Standards and Codes (ROSC) programme. Even the efforts to draw up an alternative theory of institutional reform in Latin America have been scattered. Some authors suggest redoubling the World Bank's efforts, while others advocate setting in motion competing systems of rules or even the reallocation of powers between different branches of government.[830]

This Chapter develops a theory of 'transitional' strategies for institutional reform in Latin America. This theory is built on a bottom-up approach to reform that draws from the discussions of previous Chapters on the macroeconomic features of Latin American countries, the problem of adverse selection, the role of formal and informal institutions in capital markets, and the potential interactions between institutions. Although the theory proposed in this Chapter takes measure of some conditions that are common across the region—including the frailty of state infrastructure and the dominance of family-controlled business groups—there are still context-specific differences between countries that are not reflected in the analysis.[831] The intention here is not to propose a single

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830 A de la Torre and SL Schmulker, Emerging capital markets and globalization: The Latin American experience (Stanford University Press, 2007) (the authors consider the possibility of redoubling the efforts for legal reform). RJ Gilson, H Hansmann and M Pargendler (2010) (the authors analyse the effectiveness of regulatory dualism as a development strategy); F Reyes, Corporate governance in Latin America, (2008) 29 INTER-AMERICAN LAW REV 207 (the author advocates the allocation of judicial powers to administrative agencies as a solution to the enforcement deficiencies of Latin American nations).

831 Although the capital markets of the countries analysed here have many similarities, there are still relevant differences between them that should be taken into account by policymakers. For instance, since institutional investors are much more active in Chile's stock markets than in those of Colombia or Peru, one could think of encouraging investor activism in Chile as a way to neutralize the opportunism of insiders. Of course, this would run into the usual obstacles identified in the institutional investor literature (see S Bainbridge, Shareholder activism and institutional investors, (2005) UCLA Law and Economics Research Paper No. 20). Moreover, since wealth in Chile is concentrated in a larger number of family business groups than in Colombia, competition between groups in the former country could make the political economy problems discussed in Section 2 below less intractable.

uniform solution for every country in the region, but rather to develop a framework that allows for a better understanding of how different solutions might deal with the problems faced by Latin American capital markets.

Section 2 applies some relevant findings of the literature on economic development to the specific context of Latin America. Section 3 frames some of the main challenges faced by Latin American capital markets and develops a theory of transitional strategies that could overcome these obstacles.

2. The problem of transition in Latin America

Scholars working across different disciplines have identified an underlying tension in the process of economic development.[832] The findings of this literature have been condensed into what some authors call the 'problem of transition', as explained immediately below.[833]

Countries in the early stages of development usually lack fully functioning markets and the essential state infrastructure required to support large-scale industrial activity. Against this setting, market participants can engage in relational and reputation-based exchange to support activity in a nation's developing product and capital markets. The parties that are best able to carry on exchange of this nature accumulate wealth and influence, which may eventually allow them to become the nation's economic and political elite. Although informal exchange dominated by this elite can support rapid growth during a nation's early development stages, there is an upper bound for its

[832] See M Olson, The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities (Yale University Press 1982).

[833] RJ Gilson and C Milhaupt (2011).

contribution to economic development, as exchange of this nature is limited in both scale and scope.[834]

As a nation reaches this upper bound, further economic growth may depend on the transition to a system that allows for impersonal, arm's length exchange to take place, in the manner described in Chapter I. However, this transition usually runs into two related obstacles. First, building the infrastructure required to support impersonal exchange is a costly and long-term process. Whilst this transition takes place, the introduction of reforms can dilute complementarities between local economic subsystems and erode the pre-existing system of informal exchange without providing full support for impersonal exchange.[835] As a result, the process of transition may initially slow down economic growth, which can drain the political support for the reforms designed to bring about the transition.[836]

Second, the elites that fuelled economic growth during the country's early stages of development usually stand to lose their privileged position if the transition is successfully accomplished. In fact, increased support for impersonal exchange may weaken the pre-existing system from which these elites derive their influence and grant access to new players that can challenge the local dominance of incumbents. These elites may therefore go to great lengths to block any efforts to transition towards a system that supports impersonal exchange. The political and economic power amassed by these parties during a nation's early development stages enhances their ability to oppose reform, which can turn them into a formidable obstacle to transition.

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834 Id.

835 Id. See also Chapter V.

836 Id. See also Chapters IV and V.

Significant efforts have been put to the task of finding solutions to the problem of transition in Latin America. In the specific context of capital markets, these solutions range from legal reforms designed to enhance the protection of investors—as illustrated by the legal reform programme discussed earlier—to the introduction of a new opt-in regime for listed firms in Brazil. Before looking at these and other solutions, however, it is important to frame the problem of transition in the particular context of Latin America. This exercise raises a number of questions that, with the possible exception of Brazil, have not been thoroughly addressed in the region. Who are the elites that play the title role in the account described above? How can these elites contribute to early-stage economic development? What is the nature of the benefits that these elites derive from the status quo? Is a transition to a system that supports impersonal exchange actually required in the region?[837] Would the reforms designed to facilitate the transition necessarily slow down economic growth? Have local elites actually opposed attempts at reform?

Although it would be overly ambitious to fully address all of these matters here, finding at least partial answers to some of these questions is a necessary step to understand the Latin American version of the problem of transition. This Section draws from the discussions of the previous Chapters in order to shed some light on the identity and motivations of the main players in the region's capital markets.

[837] Chapter I already provided some potential answers to this question.

A. The paradox of family business groups

The data on ownership patterns for Latin American listed firms has been historically scarce. Incomplete enforcement of disclosure rules, complex ownership structures and a lack of academic interest—at least as compared to other developing regions—all contributed to create this gap in the data. It was only five years ago that a pair of economists studying Latin America's capital markets first claimed to have filled part of this gap 'by providing a picture of the large ownership concentration in the region'.[838] The authors summed up the scant available evidence on ownership patterns in the region by looking at studies conducted in Argentina, Brazil, Chile, Colombia, Mexico and Venezuela.[839] Their findings, supplemented here by a cross-country study conducted in 2005, point to high levels of ownership concentration in all of these countries, as shown in Figures 6 and 7.

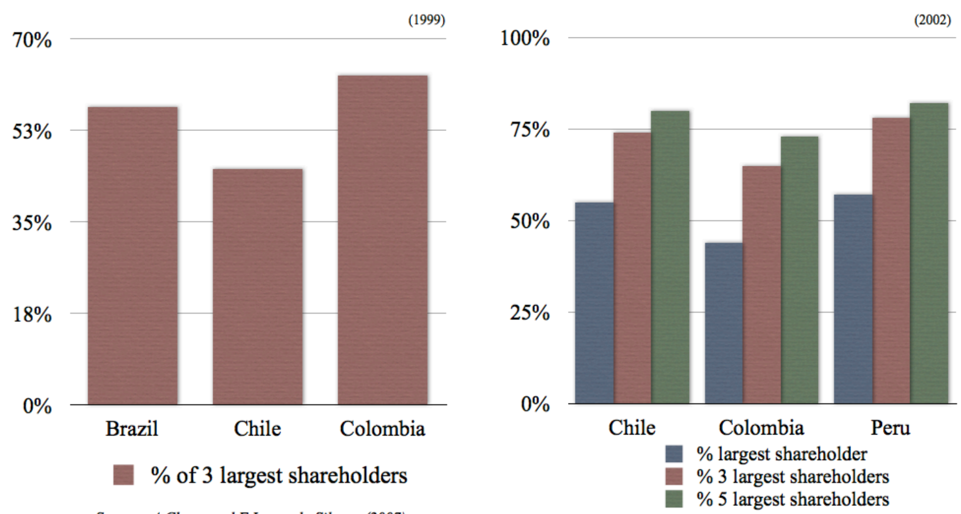
Other studies suggest that a large majority of the firms listed in Latin American stock markets is affiliated with business groups controlled by one or more local families. Figure 8 shows the percentage of business group affiliation in a sample of listed firms in Brazil, Chile, Colombia and Peru. Within this sample, the percentage of group affiliation ranges from 50% in Colombia to 100% in Peru. In turn, Figure 9 includes data on family

838 A Chong and F Lopez-de-Silanes, Corporate Governance in Latin America, (2007) Inter-American Development Bank Working Paper No. 591.

839 These studies were compiled in a book edited by the two economists mentioned in the main text, entitled Investor Protection and Corporate Governance: Firm level Evidence Across Latin America (A Chong and F Lopez-de-Silanes, eds, Stanford University Press and The World Bank, 2007). See R Bebczuk, Corporate Governance and Ownership: Measurement and Impact on Corporate Performance and Dividend Policies in Argentina; R Leal and A Carvalhal-da-Silva, Corporate Governance and Value in Brazil (and Chile); LH Gutierrez and C Pombo, Corporate Governance and Firm Valuation in Colombia; A Chong and F Lopez-de-Silanes Corporate Governance and Firm Valuation in Mexico; U Garay and M Gonzalez, CEO and Director Turnover in Venezuela.

affiliation within the ten largest business groups in these same countries. The percentages of family affiliation range from 85% in Colombia to 100% in Chile and Peru.

Figures 6 and 7
Ownership concentration in Latin America



Source: A Chong and F Lopez-de-Silanes (2007)

Source: F Lefort (2005)

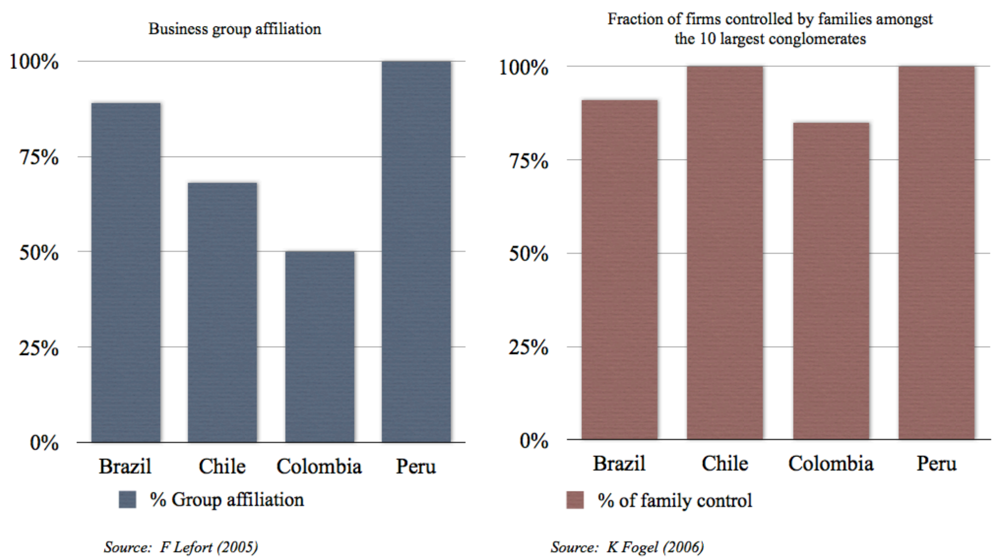
It is important to note that almost all of the studies cited above warn of the challenges involved in obtaining complete data on the ownership structure of listed firms.[840] Although information on Latin American listed firms has certainly become more available over the past decade, the data does not yet support conclusive statements about ownership patterns in the region. However, even within these limitations, it is safe to say that family business groups seem to be the dominant form of organization in Latin American capital markets.[841] The available studies, which already show high levels of

840 Lefort (2005) states that 'the most important challenge faced when preparing a review and comparison of this type is the poor and dissimilar quality of information among different countries'. See also M Santiago-Castro and CJ Brown (2007). See, however, M Donelli and others, Ownership Dynamics with Large Shareholders: An Empirical Analysis, (forthcoming 2012) J FIN QUANT ANAL (the authors built a hand-collected dataset with over 20 year of ownership information for Chilean listed firms).

841 'The dominant corporate form among large private domestic firms has long been the family-owned

affiliation to family-controlled business groups, may even understate the prevalence of this type of organization in the region, as they are based on partial and incomplete data that probably do not reflect the full extent of group dominance across particular countries.

Figures 7 and 8
Family business groups in Latin America



Latin American family business groups, also known as *grupos*, encompass networks of firms that operate across several industries—most frequently manufacturing, construction, media, energy, transportation and finance—and are often vertically

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and -controlled diversified business group, normally known in Latin America as a grupo económico or grupo'. BR Schneider, Hierarchical Market Economies and Varieties of Capitalism in Latin America, (2009) 41 J LAT AM STUD 555. For recent studies support this assertion, see R Masulis and others (2012) (data for Brazil, Chile, Colombia and Peru); R Aguilera and others (2012) ('despite all these efforts to increase economic stability and to develop financial markets, the most important firms continue to be controlled by the business groups, the Grupos'); T Khanna and Y Yafeh (2007) (data for Argentina, Brazil, Chile and Mexico) and F Lefort (2005) ('corporate governance in Latin America is conditioned by the high level of ownership concentration and the profusion of industrial and financial conglomerates controlling several companies').

integrated within each industry.[842] As opposed to conglomerates, these business groups are made up of individual firms, each with its own internal governance structures (board of directors, auditors, executive officers) and in many cases with outside investors.[843] A family or group of families retain absolute voting control over every firm in the group, often through dual class shares and pyramidal structures, which allows the network of firms to operate as a single entity.

The dominance of the *grupos* in Latin American countries fits neatly into the traditional account of the problem of transition reviewed above. Family business groups may be seen as a response to many of the limitations that are common across Latin America and other emerging regions, including weak product, labour and financial markets, as well as enforcement deficiencies and shortcomings in training and educational facilities. As illustrated in Section 2.B below, family-controlled business groups can overcome these limitations in many different ways, which makes this structure well suited to the early stages of economic development in the region's emerging areas.

At the same time, however, this pattern of ownership can give rise to particular challenges as Latin American countries develop. For the reasons explained in Section 2.C below, family business groups can crowd out standalone firms (i.e. firms not controlled by business groups or the government) that could potentially disrupt existing innovation patterns and foster higher levels of product market competition. The insiders in control of

[842] See BR Schneider, Economic Liberalization and Corporate Governance: The Resilience of Business Groups in Latin America, (2008) 4 COMP POL 40, 379-397 (pointing to evidence that, amongst the largest grupos in eight Latin American countries, 'thirty-four of forty grupos had diversified into four or five different sectors, out of a total of five').

[843] R Morck (2011).

the *grupos* also derive significant private benefits of control and rents (i.e. tax breaks, subsidies and state-sponsored monopolies) from existing institutional and political arrangements, which may have harmful effects on local economies.

As Latin American nations move past their early development stages, reforms that deal with these issues may become indispensable if the region is to support further economic growth. Nevertheless, the insiders in control of these family business groups will go to great lengths to oppose any reforms that enhance access for new firms or that curtail their benefits and rents. The political and economic power accumulated by these insiders places them in a privileged position to block any reform efforts, as suggested in the introduction to this Chapter.

It follows that there may be a tension between the positive role of the *grupos* during early-stage development and their subsequent ability to lock in institutional and political configurations that favour them but potentially slow down further economic growth. Although many other issues are relevant to understand the operation and development patterns of Latin American capital markets, the tension created by the dominance of the *grupos* is perhaps a central element of this analysis.[844] The following discussions explore this idea further, drawing from a synthesis of the explanations laid out in the previous Chapters.

844 A number of other relevant issues, such as the impact of foreign firms taking over local companies, the governance of state-controlled firms, and the operation of bond markets, are not studied here. For an analysis of these issues, see M Pargendler, State ownership and corporate governance, (2011) SSRN Working Paper available at http://ssrn.com/abstract=1854452 (on state-owned firms) and A de la Torre and others, Financial development in Latin America and the Caribbean: The road ahead, (World Bank, 2012) (on bond markets).

B. The advantages of *grupos* in early-stage development

Family-controlled business groups have the benefits that are usually attributed to controlling shareholders, conglomerates, and family firms, as well specific advantages that are particularly relevant in the context of developing countries.[845] This sub-section focuses on how the three different elements of this type of organization (i.e. controlling shareholders, group structures, family ownership) account for a number of shortcomings in local markets and state infrastructure across Latin America, with a particular emphasis on capital markets.

(i) *Controlling shareholders*

The presence of controlling shareholders can mitigate what would otherwise be acute managerial agency problems in listed firms.[846] In Latin America, product market competition does not exert significant pressure on a firm's directors and officers to perform at the best of their abilities.[847] Moreover, the deficiencies in the region's enforcement infrastructure make it highly unlikely that directors will be held liable for any breaches of their duties to the firm and its shareholders.[848] In this setting,

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845 For a summary of the advantages of 'blockholder systems', see WW Bratton and JA McCahery, Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference (1999) 38 COL J TRANS L 213, 297.

846 See Chapter II. The development and persistence of concentrated ownership may have also come about as a reaction to strong labour rights, following the analysis of European nations made by MJ Roe (see The Political Determinants of Corporate Governance, (2004) 52 AMER J COMP L 3). For an application of this analysis to the context of Latin American countries, see BR Schneider (2008) and (2009).

847 'In emerging economies, product markets, labour markets, takeover markets and other external factors are corrupted or ineffective and thus less effective in governing top managers'. MN Young and others, Corporate Governance in Emerging Economies: A Review of the Principal-Principal Perspective, (2008) 45 J MAN STUD 1, 203. It must also be stated that, given the high degree of ownership concentration, there is no market for corporate control.

848 MN Young and others (2008).

shareholders have incentives to retain voting control of listed firms in order to monitor and discipline managers or even to directly participate in the management of the firm's affairs. As explained in Chapter II, the presence of a controlling shareholder can lead to a close level of scrutiny over executives, swift intervention to remedy managerial deficiencies, a focus on long-term prospects, and the prevention of value-destroying diversification by self-interested managers.[849]

Controlling shareholders may also help mitigate adverse selection in the region's developing capital markets. To overcome this market failure, following the explanations made in Chapter II, investors in capital markets require credible assurances about the future behaviour of corporate insiders and the firm's financial performance. Across developed countries, these assurances are furnished through a combination of market forces (i.e. product market competition, the market for corporate control) that constrain opportunism, formal institutions that grant strong rights to shareholders and facilitate litigation, the intervention of market participants (gatekeepers, the press, financial analysts) that monitor and occasionally discipline insiders, and norms of good business behaviour that shape the actions of these insiders.

The weakness or absence of these elements in Latin America, a common trait across most developing countries, presents investors with an acute version of the adverse selection problem mentioned above. It is in this context that controlling shareholders can

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849 The literature that supports this statement is extensive. See, for instance, JW Howell, 'The Value of Blockholder Liquidity and the Decision to Unify Share Classes' (2010) http://ssrn.com/abstract=1571760; CG Holderness (2008); JC Coates, 'Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?' in G Ferrarini and others (eds), Reforming Company and Takeover Law in Europe (OUP, Oxford 2004); M Becht, P Bolton and A Röell, 'Corporate Governance and Control' in GM Constantinides, M Harris and RM Stulz (eds) Handbook of the Economics of Finance (Vol. 1, Elsevier, Amsterdam 2003); P Bolton and EL von Thadden (1998).

provide the assurances required by investors, through the informal institution of reputational intermediation.

The key feature behind this function of controlling shareholders is the notion of reputation used in Chapters IV and V, namely, outside expectations as to the behaviour of insiders. Due to their command over the firm's affairs, controlling shareholders are the repositories of the firm's reputation. Whereas managers and directors may be replaced against their will from time to time, controlling shareholders in developing countries will remain in control of the firm until they voluntarily decide to sell their equity stake.

The prospect of retaining long-term control over a firm gives controlling shareholders the expectation of repeat interactions over an extended time horizon with the firm's counterparties in product and capital markets. In turn, this expectation places controlling shareholders in a position to act as reputational intermediaries for listed firms under their control.[850]

The way in which controlling shareholders behave towards investors may have an impact on the price paid for the firm's shares in future equity issuances and on the firm's cost of trading with its commercial counterparties. For this reason, controlling shareholders stand to benefit financially from building up a reputation for fair dealing with investors.[851] The link between past behaviour and future terms of trade enhances the ability of controlling shareholders to credibly commit ex ante to deal fairly with investors

850 See Chapter IV.

851 This can be accomplished through actual instances of fair dealing or at least by taking steps to make outsiders believe that they are being treated fairly.

ex post.[852] This credible commitment is what ultimately alleviates the problem of adverse selection.

The commitment of controlling shareholders will be credible as long as they stand to gain more from meeting the expectations of investors than from breaking their assurances. Although many factors are relevant to make this calculation, one of its central elements is the number of expected future interactions between the controlling shareholder and outside investors.[853] The end of these interactions is usually marked by a sale of control, the decision to delist or to refrain from secondary issuances in public markets,[854] and ultimately by the death of the controlling shareholder. When controlling shareholders anticipate that this end period approaches, they may be inclined to renege on their commitments.

To sum up, the credibility of the assurances provided by controlling shareholders as reputational intermediaries for listed firms is tied to the number of expected future interactions with investors, which in turn is constrained by the end period for these interactions.

This brief summary of the explanations laid out in previous Chapters is important to understand how group structures and family ownership can magnify the ability of controlling shareholders to provide credible assurances to outside investors, which in turn

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852 This link is also important in the context of reputation-based trading in product markets, as explained in Chapter IV.

853 Under the ‘product market advantage’ model discussed in Chapter IV, the expected number of interactions with investors would not be as relevant as the expected interactions with the firm’s counterparties in product markets. As explained by Gilson (2007), outside investors in this context may be seen as ‘reputational canaries’ that signal the firm’s commercial partners about the behaviour of insiders.

854 As explained in Chapter IV, mechanisms such as dual class shares and pyramidal structures can extend the number of potential interactions between controlling shareholders and outsider investors in the context of capital markets.

hints at one possible reason for which family-controlled business groups may outcompete standalone firms for equity resources in Latin American capital markets.

(ii) *Group structures*

The formation of business groups through vertical and horizontal integration allows controlling shareholders to take advantage of internal and external market benefits. Intra-group transactions give rise to 'internal markets' that substitute for weak product, labour and financial markets and provide solutions for the problems created by the weakness of the state's enforcement infrastructure.[855] For instance, as explained in Chapter I, there are certain constraints in the supply of external finance in Latin America. To overcome this limitation, group affiliates can benefit from internal resources gathered other group firms or debt finance from affiliated banks.[856]

Another example is tied to the weakness of judiciaries across the region, which can give rise to acute hold-up costs since commercial counterparties are unable to enforce incomplete contracts. Vertical and horizontal integration within the group structure allows controlling shareholders to use the power ingrained in corporate control to administer intra-group contractual relations between suppliers, producers, transporters and firms in complementary industries.[857]

Although intra-group transactions may be detrimental to the interests of outside investors in particular affiliates, the internal market benefits they generate often redound

[855] For a review of the extensive literature produced on this topic, see T Khanna and Y Yafeh (2007).

[856] 'Even if underdeveloped institutions make it optimal for a firm to substitute internal markets for public markets and thus become large, financing constraints may prevent it from growing to its optimal size'. T Beck, A Demirgüç-Kunt and V Maksimovic, The influence of financial and legal institutions on firm size, (2006) 30 J BANKING FINANCE 11, 2996.

[857] See Chapter I.

to the interests of the group as a whole. Accordingly, these benefits may be captured by outside investors in other affiliates or those that hold shares in the group's main holding company.

The 'external market' benefits tied to business groups can also make up for essential shortcomings in Latin America. Leaving aside the possibility of enhanced reputation-based trading in product markets—which, as mentioned above, can substitute for poor contractual enforcement—group structures may have two distinct functions in the region's developing capital markets.[858]

The first function concerns the substitution of signals about a firm's profitability, as discussed in Chapter IV.[859] The second function involves the multiplying effect that the group structure has on the ability of controlling shareholders to act as reputational intermediaries.[860] Since the controlling shareholders of a business group are the repositories of the entire group's reputation, this ownership structure extends the number of potential interactions between these insiders and the firm's counterparties. To this effect, the data presented earlier suggest that business groups in Latin America often have several affiliates listed in local capital markets. Whenever a group affiliate goes public or undertakes secondary issuances, investors will price the offering with reference to the reputation of its controlling shareholders in handling the entire group's affairs.[861] In other

858 For an explanation of reputation-based trading in product markets, see Chapter IV.

859 In developed countries, the relations between a firm and certain market participants (i.e. VC funds, gatekeepers, financial analysts) can send a credible signal to outside investors as to the future profitability of the firm at the time of an IPO. However, these market participants are either absent or generally unable to fulfill a similar role in most Latin American countries. Affiliation to a business group may provide a substitute for this signal, which can boost the IPO performance of group firms.

860 See R Masulis and others (2012) and Chapter IV.

861 To this effect, 'a group's track record in establishing, managing, and/or monitoring multiple firms substitutes for underdeveloped investor protection regulations'. R Masulis and others (2012) 3.

words, the observable actions of controlling shareholders in one affiliate may have an impact on the cost of capital of all the group's affiliates.[862]

These external market benefits may grant an advantage to the controlling shareholders of business groups over those of standalone firms in the pursuit of equity resources in local capital markets. In fact, the insiders in control of a standalone firm may have a hard time finding a substitute for the profitability signals mentioned above, which could give group affiliates an edge over standalone firms in equity markets. Moreover, since the group structure extends the number of potential interactions with outside parties, the assurances provided by the controlling shareholders of a business group will often be more credible than the assurances provided by the controlling shareholders of a standalone firm.

(iii) *Family ownership*

Family ownership can facilitate informal commitments with the firm's workforce and firm-specific human capital investments by non-family executives, functions that are relevant in both developed and developing countries.[863] In Latin America and other emerging nations, however, family ownership is highly useful as it improves the ability of controlling shareholders to act as reputational intermediaries.

Controlling families are often inclined to hold on to control in pursuit of transgenerational wealth and the preservation of family traditions, a pattern of behaviour

862 As explained in Chapter IV, the reputation of controlling shareholders can also have an impact on the group's cost of engaging in relational exchange with third parties in industries in which the group does not have any operations.

863 For a full list of the advantages associated with family ownership, see RC Anderson and DM Reeb, Founding-Family Ownership and Firm Performance: Evidence from the S&P 500, (2003) 58 J FINANCE 1302.

that is common across Latin America.[864] Family control may therefore extend the end period in the interactions between these insiders and the firm's counterparties, as control will be expected to remain with the family for successive generations.[865] The status of the family as long-term repeat players in local markets enhances its ability to commit credibly ex ante to deal fairly with investors ex post. Accordingly, the controlling shareholders of family firms may have an advantage over the controlling shareholders of non-family firms in the pursuit of equity resources in capital markets.

(iv) *The private sector 'Big Push'*

Taken together, the advantages of family-controlled business groups in Latin America can be substantial. Aside from favouring the insiders in control of the *grupos*, however, these ownership structures have been associated with positive macroeconomic outcomes.[866]

A burgeoning literature suggests that group structures are 'an elegant solution to the coordination problems associated with rapid industrialization'.[867] The idea behind this view is that developing countries lack the 'network of existential externalities'—including, *inter alia*, effective production and pricing in complementary industries, access

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864 Family ownership is common in Latin America across listed and unlisted firms of all sizes. See LF Andrade and others, All in the *Familia*, (2001) 4 McKinsey Quarterly 1. See also OECD, Governance Challenges for Family Businesses (2009) available at http://www.oecd.org/dataoecd/1/26/43654301.pdf (Family firms are the 'leading form of business organization in Latin American countries, even among large listed companies') and RJ Gilson (2006) 1673.

865 See Chapter IV.

866 This may be due to complementarities between the different features of business groups and local macroeconomic traits such as financial systems tilted towards banks, manufacturing-based industries and incremental innovation processes. See BR Schneider (2009).

867 R Morck, Finance and governance in developing economies, (2011) NBER Working paper No. 16870, 11.

to finance, transportation infrastructure, a pool of qualified employees, effective mechanisms for dispute resolution, education and training facilities—required to support sustained economic growth.[868] As suggested by the explanations above, family-controlled business groups can overcome many of these problems. In doing so, these organizations can fuel the early-stage development of emerging countries under what has been labelled a private sector 'Big Push':

> *Classic Big Push industrialization envisions state planners coordinating economic activity to internalize a range of externalities that otherwise lock in a low-income equilibrium, but runs afoul of well-known government failure problems. Successful Big Push coordination may occur instead when a large business group, acting in its controlling shareholder's self-interest, coordinates the establishment and expansion of businesses in diverse sectors.*[869]

C. The downside of Latin American *grupos*

Although the discussion above focused on the many advantages associated with family-controlled business groups in developing countries, the preceding Chapters also point to a number of problems that either arise or are exacerbated by the presence of these ownership structures. Following the order set out above, the discussion below looks at the downside of controlling shareholders, group structures and family ownership in Latin America.

868 R Morck (2011).

869 Id.

(i) *Controlling shareholders*

Chapter II described in detail how the exercise of corporate control by shareholders with an absolute voting majority could produce 'private benefits'. The extraction of these private benefits of control shifts value away from outside investors, as in the cases of cash flow, asset and equity tunnelling or the pursuit of amenity potential in ways that impose a financial burden on the firm.[870]

Although private benefits of control may be seen as fair compensation for the benefits that controlling shareholders bring to the firm, this argument must be qualified in the Latin American context.[871] Developing jurisdictions often lack most of the constraints that set limits to the ability of controlling shareholder to extract private benefits of control (strong legal systems, market forces, sophisticated market participants, etc.) in developed nations. For this reason, controlling shareholders have room to seize firm value well beyond what can reasonably be seen as fair compensation for their value-enhancing contributions to the firm.[872]

The previous sub-section explained how reputational intermediation by controlling shareholders could set some limits to the extraction of private benefits of control. However, even controlling shareholders that expect to be long-term repeat players in capital markets—who would have incentives to limit their consumption of private benefits in order to build up reputational capital—might on occasion be inclined

[870] On a related note, these private benefits also provide incentives for controlling shareholders to hold on to control. When a firm issues shares in public markets, its insiders can retain control through the use of dual class shares, shareholders agreements, and other mechanisms that separate voting power from cash flow rights. As explained in Chapters II and IV, the use of these mechanisms can increase the propensity of controlling shareholders to capture private benefits, to the detriment of outside investors.

[871] WW Bratton and JA McCahery (1999).

[872] RJ Gilson and A Schwartz (2012).

towards the ‘excessive’ extraction of private benefits.[873] This could happen when the end period for the relation between controlling shareholders and investors crystallizes or even in times of financial turmoil, as illustrated by the events surrounding the East Asian crisis of 1997.[874] Controlling shareholders that are long-term repeat players in capital markets may also ‘excessively’ consume private benefits when outside parties are unable to observe or assess the actions of these insiders, an issue that is revisited in Section 3 below.[875]

(ii) *Group structures*

Intra-group transactions between affiliates can give rise to the ‘internal market’ benefits described above. However, the controlling shareholders of groups may also use the close relations between affiliated firms to extract private benefits that are not shared with any outside investors in the group.[876] The frequency and scope of intra-group transactions often provides a cover for self-dealing, as it is difficult for outsiders to distinguish between legitimate dealings amongst affiliates and transactions aimed at extracting private benefits of control.[877]

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873 As used here, the term ‘excessive’ means simply that the costs to outside investors of private benefit extraction surpass the benefits tied to the presence of a controlling shareholder. RJ Gilson and A Schwartz (2012).

874 MN Young and others (2008). During periods of financial turmoil, a potential slump in the firm’s economic activity may lead insiders to assign a lower value to the benefits of cooperation. This could impair the ability of reputation to influence the behaviour of insiders.

875 As explained in Chapter II, the lack of effective limits on the ability of controlling shareholders to extract private benefits of control is one of the causes of the adverse selection problem in developing capital markets.

876 BR Schneider (2008) and (2009).

877 MN Young and others (2008). It is also relevant to note that the structure of certain business groups can increase the incentives of controlling shareholders to expropriate outside investors. As explained in Chapter IV, pyramidal structures allow these insiders to exercise voting control over the entire group with disproportional cash flow rights in the group’s affiliates. A pyramidal group

Moreover, group structures may fuel the expansion of business empires that control large portions of a nation's economy, which can give rise to certain drawbacks. As explained above, groups have financing advantages tied to their ability to use intra-group funds and debt finance from affiliated banks ('internal market' benefits), as well as to their ability to outcompete standalone firms for equity resources in local capital markets ('external market' benefits). These financing advantages not only allow business groups to crowd out standalone firms, but also enable a few individuals to amass wealth and influence far in excess of what would be possible without a group structure in place. This outcome may give rise to at least two problems.

First, as explained in Chapter I, large business groups in emerging countries often focus on incremental innovation and the preservation of the markets from which they profit rather than investing in new products and technological processes.[878] The standalone firms that could potentially engage in 'revolutionary' innovation and disrupt the local dominance of the *grupos* will find it hard to compete against these groups due in part to the advantages mentioned above. As a result, the presence of large business groups may constrain competition and 'revolutionary' innovation in developing countries.

Second, the concentration of wealth in a few individuals grants them considerable political and economic influence, particularly in small economies such as those of Latin

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structure can therefore exacerbate the agency problem between controlling shareholders and outside investors, a problem that can be compounded by the use of dual class share structures and other mechanisms to further separate voting rights from cash flow rights. To this effect, the available data suggest that Latin American *grupos* are often structured as pyramidal groups and frequently issue non-voting shares in the region's capital markets. R Aguilera and others (2012); T Khanna and Y Yafeh (2007); M Santiago-Castro and CJ Brown (2007).

[878] I Mahmood and W Mitchell (2004).

America.[879] Chapter I explained how these individuals were ideally placed to oppose any reform efforts with the potential to erode their local dominance. The inability to introduce these reforms may hinder a country's ability to facilitate capital market access for standalone firms and constrain the 'excessive' extraction of private benefits in family-controlled business groups.

(iii) *Family ownership*

Family firms have traditionally been linked to a series of problems that arise from the close relations between the insiders in control of the firm. To list just a few, family ownership can multiply the incentives of controlling shareholders to divert firm assets away from outside investors, increase the probability that inexperienced individuals are appointed to the firm's top management positions, lead to poor business decisions motivated by the pursuit of amenity potential and harm the firm's performance due to conflicts between family members.[880]

(iv) *Locked-in extractive elites*

The political and economic power amassed by the families in control of Latin American *grupos* lends itself to a more negative reading than the one described above for the private sector 'Big Push'. These organizations may in fact fit the claims made by the political economy literature on the negative impact of highly influential and well-

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[879] BR Schneider (2009) suggests that the four largest *grupos* generated 20% of Colombia's GDP in 1998 and, in Chile, around 50 conglomerates controlled more than 90% of the assets in listed non-financial firms during the 1990's.

[880] B Villalonga and R Amit, 'How are US Family Firms Controlled' (2009) 22 RFS 3047, 3091; MN Young and others (2008).

organized constituencies, which can lead to political rent-seeking, regulatory capture, and effective opposition to institutional reform.[881]

Of course, these problems are common across developed nations, where powerful interest groups can hold sway over politicians and regulators. For instance, recent revelations in the UK have shed light on the allegedly sizable influence of the Murdoch family's media empire over successive governments in the UK for the last two decades.[882] In the US, the financial industry has considerable leverage over legislators and regulators, which may have been used to oppose new regulation and to water down the effects of existing rules.[883]

However, whereas these examples concern a single industry in a large economy, Latin American *grupos* exert their influence over several industries—often including both the media and the financial industry—in much smaller economies. Leaving Brazil aside, Latin America is home to nine of the 100 wealthiest individuals in the world, all of who are the heads of a widely diversified family business group.[884] In Colombia, for instance, the Sarmiento family group controls the largest newspaper with national circulation in the

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881 There is an extensive literature on the prospectively negative role of tightly coordinated and influential interest groups. For a general theory of interest groups and politics, see M Olson, The Logic of Collection Action: Public Goods and the Theory of Goods (Harvard University Press 1971) and M Olson (1982); AO Krueger, The Rent-Seeking Society (1974) 64 AMER ECON REV 3, 291-303. For specific applications of these precepts to the context of financial markets, see R Morck (2011); RJ Gilson and others (2010); T Khanna and Y Yafeh (2007); K Fogel, Oligarchic Family Control, Social Economic Outcomes, and the Quality of Government, (2006) 37 J INT BUS STUD 603-622; R Rajan and L Zingales, The great reversals: The politics of financial development in the twentieth century, (2003) 69 J FIN ECON 5 and LA Bebchuk and MJ Roe (1999).

882 An inquiry launched over a phone-hacking scandal in the UK has uncovered close dealings between Rupert Murdoch's businesses and UK politicians. See http://www.levesoninquiry.org.uk/

883 For the US, see JC Coffee, The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated (2012), Columbia Law and Economics Working Paper No. 414.

884 The list of the world's wealthiest individuals, compiled by Forbes Magazine, includes four Mexicans, three Chileans and two Colombians. See http://www.forbes.com/billionaires/list/

country (El Tiempo), as well as four of this nation's largest banks (Banco Popular, AV Villas, Banco de Occidente and Banco de Bogotá).[885] The Luksic group of Chile controls one of the world's largest cooper mining companies (Antofagasta), as well as Chile's largest bank (Banco de Chile), the largest brewer and second largest producer of wine (Compañía de Cervecerías Unidas), and a major TV and radio broadcasting company (Canal 13).[886]

Latin American *grupos* such as these may give rise to a perfect storm of political economy problems. The concentration of vast wealth in the hands of a few families with interests across key industries in small economies grants the *grupos* a muscular influence over regulators and politicians in their home countries. This influence can manifest itself through several different channels.

The *grupos* are usually able to organize themselves into tightly coordinated political pressure groups that can overcome collective action problems in the public sphere.[887] One visible example of this behaviour involves the influence of the *grupos* over the associations that formally represent the interests of market participants before local and national governments and legislators. Most Latin American countries have at least one nation-wide and several more industry-wide associations and 'chambers' that represent business interests. Aside from frequent contacts with policymakers, these organizations often have strong media departments that liaise with the local press and

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885 See the profile of Luis Carlos Sarmiento at http://www.forbes.com/profile/luis-carlos-sarmiento/. Incidentally, the head of the Sarmiento family group, which operates mostly in Colombia, has managed to amass a fortune that almost doubles the size of the wealth attributed to Rupert Murdoch, the head of the global media empire mentioned in the text above (see http://www.forbes.com/billionaires/list/).

886 See http://www.forbes.com/profile/iris-fontbona/

887 This ability to organize resembles that of the small groups with 'disproportionate organizational power for collective action' described by Mancur Olson. See M Olson (1971) and (1982).

research departments that publish studies generally supporting pro-business views.[888] Table 2 shows a small sample of these organizations in Chile, Colombia and Peru.

Table 2
Sample of associations representing business interests

Country	Nation-wide	Industry-wide	Chambers
Chile	Confederación de la Producción y el Comercio	Sociedad de Fomento Fabril	Cámara Chilena de la Construcción
Colombia	Asociación Nacional de Empresarios de Colombia	Asociación Bancaria y de Entidades Financieras	Cámara Colombiana de la Infraestructura
Peru	Confederación Nacional de Instituciones Empresariales	Sociedad Nacional de Industrias	Cámara Peruana de la Construcción

Sources: Prochile, OhPeru and BR Schneider (2010a)

Although these organizations exist in most countries across the world, there is at least one important difference between the business lobby groups that operate in the developed world and those found in Latin America.[889] Family business groups in Latin America can often exert a dominant influence over *several* industry-wide associations. Since the *grupos* usually control the largest firms in each sector, they are likely to be the

888 BR Schneider, 'Business Politics in Latin America: Patterns of Fragmentation and Centralization' in The Oxford Handbook of Business and Government (W Graham and others, eds, OUP 2010a).

889 See, for instance, the Confederation of British Industry (CFI) in the UK and the United States Chamber of Commerce (USCC) in the US.

largest contributors of membership dues to the associations that represent the interests of each industry, which makes it difficult for these associations to ignore the will of the *grupos*.[890] At the same time, a single *grupo* can exert significantly more pressure over the managers of an industry-wide association than many small players facing collective action problems.[891]

Diversification strategies within the *grupos* often allow them to extend their dominant influence over more than one industry-wide association. For instance, a single *grupo* with a strong presence in several sectors (i.e. the Sarmiento group in Colombia or the Luksic group in Chile) could mobilize the associations formed in of all these sectors to either support or block a particular initiative.[892] This confluence of interests allows family business groups to coordinate their efforts to a degree not likely to be matched by the lobby groups of more developed nations, which may often represent competing interests across different industries.[893]

Latin American family business groups also have the ability to directly influence regulators and politicians.[894] The *grupos* have historically been a major source of campaign finance across the region.[895] The *grupos* have also been known to use media companies under their control to promote cooperative candidates and disparage their

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890 The *grupos* have a 'powerful say in setting an association's political agenda'. A Rettberg, Business Versus Business? *Grupos* and Organized Business in Colombia, (2005) 47 LAT AM POL AND SOC 1, 42.

891 A Rettbert (2005).

892 M Olson (1982) ('it would be in the interests of those groups that are organized to increase their own gains by whatever means possible') 37.

893 To this effect, since Latin American *grupos* usually do not compete against each other, there may be few interest groups with competing interests that could counteract the influence of one *grupo* across multiple industry associations. R Morck (2011).

894 Family business groups 'combine individual and associational strategies to maximize their overall interests'. A Rettbert (2005) 45.

895 BR Schneider (2010a); A Rettbert (2005).

opposition. Televisa, a Mexican company controlled by the Azcárraga family group that operates the country's largest TV network, was recently involved in a scandal for allegedly 'manipulating its coverage to favour the leading candidate [for the Mexican presidential election], Enrique Peña Nieto'.[896] Of course, strategies such as this one are certainly not unique to Latin America.[897]

It is also common for these groups to have close ties with local politicians or even for group-related family members to occupy political office.[898] The current presidents of Colombia and Chile, for instance, have respectively formed part and had close ties with local family business groups.[899] Cabinet posts in some countries in the region are often filled with members of the business elite.[900] Table 3 shows the number of 'business appointees' (i.e. prominent members of the business community) to ministerial cabinet posts in Chile, Colombia and Peru.[901] Although more informal ties between the political

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896 See Computer Files Link TV Dirty Tricks to Favourite for Mexico Presidency, GUARDIAN, (7 June 2011).

897 Despite its motto of 'fair and balanced' reporting, the Fox network in the US—controlled by the Murdoch family mentioned earlier—is renowned for its outspoken support of the Republican Party.

898 R Morck (2011).

899 President Sebastián Piñera of Chile used to be the head of a large group with interests in real estate, television (Chilevisión), football (Colo Colo) and an airline (LAN Chile). Before he sold his stake in LAN Chile in order to avoid conflicts of interest as he gained political office, President Piñera controlled the airline through a shareholders' agreement with the Cueto family, a prominent family business group in Chile (see Piñera Analiza sus Inversiones en LAN, CNN (22 January 2010). President Santos of Colombia belongs to the family that until recently controlled a media powerhouse in the country, including the El Tiempo newspaper mentioned in the main text. Members of the Santos family have traditionally held political office in Colombia, including President Eduardo Santos (1938-1942) and Vice-president Francisco Santos (2002-2010).

900 BR Schneider, 'Business Politics and Policymaking in Contemporary Latin America' in How Democracy Works: Political Institutions, Actors, and Arenas in Latin America Policymaking, (C Scartascini and others, eds., IADB-Harvard 2010b).

901 As noted by BR Schneider (2010b), the tendency to appoint members of the business elite to cabinet posts may vary significantly depending on the political orientation of the government in power.

and economic elite are notoriously difficult to document, some anecdotal evidence of these ties has become increasingly available in recent years.[902]

Table 3
Business appointees to cabinet posts

Country	Government	Number of appointees	% of total cabinet posts
Chile	Piñera (2010-2012)	10	47%
Colombia	Uribe (2002-2010)	7	54%
Peru	Humala (2011-2012)	5	31%

Adapted from BR Schneider (2011) and (2010).

The propensity of Latin American families to retain control over a *grupo* for successive generations also grants them important advantages.[903] As these families are long-term local players, politicians and government officers expect to interact repeatedly with them over extended periods of time.[904] This expectation of repeat interactions facilitates cooperative behaviour between group insiders and politicians, much like it allows these insiders to engage outside investors in capital markets. Moreover, since Latin American family business groups participate simultaneously in many industrial

902 For a summary of the evidence, see BR Schneider (2010b).

903 P Fernández-Pérez and M Fernández Moya, Making Room for Emerging Economies: A Comparative Approach of the Largest Family Businesses in China, Mexico and Brazil, (2011) 5 UNIVERSIA 1, 76-93; BR Schneider (2008).

904 R Morck and B Yeung, Family Control and the Rent-seeking Society, (2003) William Davidson Institute Working Paper No. 585.

sectors, these insiders have multiple chances of confronting uncooperative politicians and government officials.[905]

The *grupos* may be unique in their ability to combine all of the traits described above, that is, high organizational capabilities, the power to exert influence through their dominance of multiple industries, close personal links with the political elite, the capacity to engage in long-term relations with politicians and policymakers and to punish those that do not cooperate.[906] The ability of the *grupos* to combine these traits may exacerbate the problems of political rent-seeking, regulatory capture, and opposition to institutional reform that were mentioned above.

The *grupos* may be particularly effective political rent-seekers. Rent-seeking has been described as 'self-interested dealings between the political and business elites', which allows these elites to capture 'unearned income' from ad-hoc local arrangements.[907] These rents usually come in many forms, including governmental concessions, licenses, tax breaks and state-sponsored monopolies in certain industries.[908] Aside from these rents, Latin American *grupos* have traditionally benefited from protectionist measures instituted by congenial governments, such as 'restrictions on

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905 BR Schneider (2008); R Morck and B Yeung (2003).

906 'Oligarchic families plausibly have an innate advantage as political rent seekers because of their blood ties with political elites, longevity, small number, ability to precommit, discretion, power to punish, and multiple simultaneous business operations […] while non-family controlling shareholders might enjoy some of these advantages, and long serving professional CEOs others, only long-established very wealthy families in control a country's great corporations enjoy them all'. R Morck and B Yeung (2003).

907 See R Morck and B Yeung (2003) and AO Krueger (1974).

908 Latin American *grupos* often derive significant advantages from special government policies: 'Government commitment to a "national bourgeoisie", using the policies of the day, gives business groups a leg up'. BR Schneider (2008).

foreign ownership, discrimination in public contracts, sympathetic regulations, or subsidized credit'.[909]

Family business groups are also ideally placed to capture the regulators charged with the oversight of their operations.[910] It seems almost self-evident that public officials will have few incentives to openly oppose the interests of a business group with control over large portions of a nation's economy and close ties to the highest echelons of government. Even those regulators with the mettle to oppose the interests of a *grupo* may be swiftly forced out of office.[911] This may lead to capital market regulation tailored to the interests business groups and the under-enforcement of even the most basic disclosure rules.

Finally, for the reasons explained earlier, the *grupos* have both the incentives and the power to block any reforms that could erode their privileged position within the local economy.[912] In the context of capital markets, the *grupos* may have ample space to set a policy agenda that allows them to preserve the political and institutional arrangements that favour their interests. Capital market regulation is mostly an issue with low political salience in Latin America, as the region's stock exchanges are not large enough to sustain

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909 BR Schneider (2008). See also A Rettberg, The Political Preferences of Diversified Business Groups: Lessons from Colombia (1994-1998), (2001) 3 BUSS AND POL 1.

910 For an analysis of public choice theories and capture, see GJ Stigler, The Theory of Economic Regulation (1971) 2 BELL J ECON MAN SC 1, 3-21 and RD Tollison, Public Choice and Legislation, (1988) 74 VIRG L REV 2, 339-371.

911 In Colombia, for instance, the head of the Competition Authority (SIC) was subtly forced out of office in 2001 for blocking a merger between the country's two largest airlines, one of which was controlled at the time by the influential Santo Domingo family group. Although the head of the SIC was not formally fired, he was prevented from deciding over a recourse submitted after he had objected to the merger. See Avianca SOS Revista Semana (17 September 2001) and Nunca Prejuzgue, Revista Semana (24 September 2001). See also Avianca-Aces faces new obstacles, Airline Business (1 October 2001) available at http://www.flightglobal.com/news/articles/aces-avianca-faces-new-obstacles-136853/.

912 M Olson (1982); R Rajan and L Zingales (2003).

a strong constituency of investors that could muster the political support required to introduce effective reforms in this field.[913] Although institutional investors in Chile and retail investors in Colombia might fulfil this role in the near future, these constituencies would still have to overcome significant obstacles to counteract the ascendancy of the *grupos*. To boot, the almost complete lack of major corporate scandals involving listed firms—a possible offshoot of regulatory laxity and incomplete enforcement—reduces the possibility of a political backlash that could offset the influence of the *grupos* over legislators and regulators.[914]

To sum up, Latin American *grupos* seem well suited to play the role of the entrenched extractive elites with disproportionate political and economic power who feature prominently in the political economy literature:

> *[Oligarchic family controlled firms] use their economic power to reap political advantages and shape institutional development to preserve the status quo, curtail competition and innovation, and impede growth'*.[915]

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913 On the impact of political salience on the regulation of the rules that govern corporate control, see PD Culpepper, Quiet Politics and Business Power: Corporate Control in Europe and Japan (Cambridge University Press 2011). It must be noted that the capital market reforms introduced in Latin America over the past decade have mostly been promoted by supranational organizations, instead of local constituencies.

914 One exception concerns the incident known as the 'Chispas scandal' in Chile. See T Wigodski, Caso Chispas: Lealtad Debida en el Directorio de una Sociedad, (2008) Universidad de Chile Working Paper, available at http://tere.r-t.cl/ei/2007_08/Paper_6.pdf.

915 K Fogel (2006). See also D Acemoglu and Robinson, Why Nations Fail: Who are the Extractive Elites?, (2012) ('[Extractive elites] will often support economic institutions and policies inimical to sustained economic growth. Sometimes they will block new technologies; sometimes they will create a non-level playing field preventing the rest of society from realizing their economic potential; sometimes they will simply violate others' rights destroying investment and innovation incentives') (available at http://whynationsfail.com/blog/2012/5/1/who-are-the-extractive-elites.html).

3. Transitional strategies

The field of institutional reform has a long track record with mostly mixed results.[916] A string of botched reform efforts in developing countries over the past two decades has provided grounds for many authors to conclude that we do not yet fully understand the intricacies involved in the process of reforming institutions.[917] This conclusion seems to accurately describe the experience with legal reform in Latin American capital markets.

Starting in the late 1990's and supported by a burgeoning law and finance literature, international development organizations such as the World Bank and the OECD embraced the notion that the improvement of legal protection for outside investors was the key to stock market development in emerging countries.[918] A top-down reform programme was quickly drawn up to introduce legal rules designed to enhance the quality of disclosure and investor protection mechanisms in these jurisdictions.[919] The blueprint for these reforms was visibly the Anglo-American system of corporate law and securities regulation, considered by many to be the state of the art in investor protection.

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916 KE Davis and MJ Trebilcock, The Relationship Between Law and Development: Optimists Versus Skeptics, (2008) 56 AMER J COMP L 895.

917 For a summary of the studies that support this view, see M Mota (2011) and D Rodrik (2008).

918 Some of basic underpinnings of this literature can be found in the work of the economists that provided the empirical basis for the legal origins theory. See S Djankov and others, 'The Law and Economics of Self-Dealing' (2008) 88 JEL 430, 465; R La Porta and others, 'The Economic Consequences of Legal Origins' (2007) 46 JEL 285, 332; R La Porta and others, 'What Works in Securities Laws?' (2006) 61 J FINANCE 1, 32. This theory has visibly influenced the initiatives of supranational organizations, as seen in the OECD 'Principles of Corporate Governance' (adopted 1999, modified 2004), 'White Paper on Corporate Governance in Latin America' (2004) and 'White Paper on Corporate Governance in Asia' (2003) and the World Bank's ROSC (Reports on the Observance of Standards and Codes) programme.

919 'Understandably, formal legal rules are easier for economists to code, measure, and incorporate into their regression equations, but they may have little to do with the reality of actual practice, particularly in developing countries'. JC Coffee (2007). The importance that certain academics attribute to these variables brings to mind the six mathematical constants that govern the laws of physics: 'Our whole Universe is governed by just six numbers, set at the time of the Big Bang. Alter any one of them at your peril, for stars, planets and humans would then not exist'. M Rees, *Just Six Numbers* (Basic Books, London 1999).

Although many governments across the developing world followed the recommendations of the World Bank and the OECD, the legal reform programme was particularly influential in Latin America.[920] Most countries across the region enacted new legal statutes with mainstream corporate governance rules, whilst some nations set out codes of best practice for listed firms.[921] These new measures for listed firms, along with the general framework of company law, make up a regulatory smorgasbord that includes everything from fiduciary duties of directors to piercing the veil and majority abuse remedies.

There is now a considerable degree of formal legal convergence between Latin American countries and developed nations with regard to the regulation of listed firms. However, available theoretical and empirical studies seem to suggest that formal convergence did not have the intended effects in the region. There is some theoretical support for the idea that reform programmes based on legal transplants from Anglo-Saxon countries may be inadequate to deal with the particular problems that are present in developing nations.[922] It has also been suggested that deficiencies in Latin America's enforcement infrastructure have weakened the impact of the legal reforms introduced in the region.[923] Even economists working under the aegis of the World Bank have

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920 Latin American nations often compete against each other to gain a place in the 'Top Ten Reformers' ranking managed by the World Bank's Doing Business department.

921 F Reyes (2008).

922 D Rodrik (2008); D Berkowitz, K Pistor and JF Richard (2003).

923 F Reyes (2008). Empirical tests that review legal reform programmes around the world suggest that 'legal convergence has not been translated into financial development of the kind predicted by the legal origins approach, or at least not yet'. J Armour and others (2010a). See also S Deakin (2010).

suggested that these legal reforms have not had the intended effects in Latin America, as the region's capital markets remain underdeveloped.[924]

Although it may be too early to conclude that the legal reform programme has completely failed to accomplish its stated goals in Latin America, the doubts surrounding the effectiveness of these efforts have created the space for scholars to explore alternative paths to facilitate capital market development. Important contributions have already been made towards this end. This Section identifies the unifying ideas that underpin these efforts in order to develop a theory of how 'transitional strategies', a notion defined below, may assist in the development of capital markets in Latin America.

A. An introduction to transitional strategies

It has been suggested that bottom-up reforms based on 'second-best' institutions that work with local capabilities and take into account pre-existing arrangements between different constituencies may be better suited for developing countries than top-down reform based on 'best-practice' institutions.[925] One example of this approach concerns the idea of enhancing informal exchange in jurisdictions in which contracting parties cannot rely on the judicial system to enforce formal contracts. Instead of investing in the costly and long-term process of building a fully functioning judicial system, it has been suggested that developing countries may benefit from focusing first on 'improving information gathering and dissemination about the reputation of firms', as a prelude to

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924 A de la Torre and others, Financial development in Latin America and the Caribbean: The road ahead, (World Bank, 2012); A de la Torre and SL Schmulker, Emerging capital markets and globalization: The Latin American experience (Stanford University Press, 2007).

925 D Rodrik (2008).

more structural reforms aimed at enhancing impersonal exchange.[926] Moreover, should the reform of formal institutions be pursued, the 'second-best' approach suggests focusing initially on firms that 'do not have access to relational contracting'.[927]

Another contribution to this field develops the idea of 'institutional bypasses', according to which emerging countries could simply design new mechanisms to deal with existing problems instead of fixing dysfunctional institutions.[928] A leading example of an institutional bypass is the *Poupatempo* reform undertaken in Brazil, which created a new centralized venue for the provision of governmental services that operated in parallel with the incumbent federal and state agencies that provided the same services.[929]

In the specific field of capital markets, a group of scholars have suggested that a strategy of 'regulatory dualism' could overcome political economy problems in order to create space for standalone firms to access equity resources.[930] Regulatory dualism is a kind of institutional bypass. It consists of setting up a new and improved legal regime into which listed firms can opt without changing the rules that govern the operation of incumbents. One of the central examples of regulatory dualism at work in developing countries is the *Novo Mercado* set up by the BOVESPA stock exchange in Brazil. The Novo Mercado is a specialized listing segment with stringent mandatory rules designed to increase transparency and improve the rights of minority shareholders.[931] However, since these rules only govern those firms that voluntarily decide to list in this market segment,

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926 Id. at 101.

927 Id.

928 M Mota (2011).

929 Id.

930 RJ Gilson, H Hansmann and M Pargendler (2010).

931 MH Santana and others (eds), 'Novo Mercado and its Followers: A Case in Corporate Governance Reform' (2008) International Finance Corporation http://www.ifc.org.

incumbent firms can continue to operate under the pre-existing system of rules. This strategy therefore allows new firms to signal their good quality to investors, whilst simultaneously dealing with the political economy problem described in the previous Section.[932]

The strategies described above share certain traits that differentiate them from the 'best-practice' reforms proposed by the World Bank and the OECD. First, each strategy works with local capabilities in order to find a solution to some of the specific problems that impair market exchange in a particular jurisdiction.[933] In the case of 'second-best' reforms, the solution consists of a gradual process of enhancing institutions that already work in practice, instead of replacing them with 'best-practice' institutions. Institutional bypasses seek to create new ways to deal with specific problems, which is accomplished by creating a parallel avenue that takes into account local needs and capabilities. Second, when these strategies are successful, they have the potential to nurture a constituency that will promote further change. Third, as it will become clear from the explanations below, each strategy has the potential to neutralize the adverse economic effects commonly associated with the problem of transition.[934]

These traits are the defining characteristics of a 'transitional strategy', a term used here to denote specific institutional arrangements designed to deal with the problem of transition described in the previous Section.[935] Transitional strategies for institutional

932 RJ Gilson, H Hansmann and M Pargendler (2010).

933 MN Young and others (2008) ('researchers and practitioners need to be aware that corporate governance problems in emerging economies will require different solutions from those generated from a mainstream agency theory perspective, which 'assumes away' institutional differences').

934 G Roland, Transition and Economics: Politics, Markets and Firms, (MIT Press, 2000) 194.

935 The term 'transitional' refers to the fact that these strategies are designed to assist in the smooth transition to a more balanced financial system and not to the temporary nature of the specific

reform are defined by their ability to (i) rely on local capabilities to deal with clearly identified problems, (ii) build a support base for future institutional reforms and (iii) reduce the economic impact of transition.

In the specific context of Latin American capital markets, the first trait described above concerns the need to find solutions that can help neutralize adverse selection and overcome the political economy obstacles mentioned earlier. The second trait involves the expansion of an investor base that will demand further protection for their rights as the opportunity arises. Finally, the third trait would require the preservation of the incumbent system until a successful transition can be accomplished.

Since transitional strategies involve ad-hoc solutions that are specifically tailored to each jurisdiction, they have the advantage of generating fewer adjustment costs and putting less stress on existing social and political arrangements than 'best-practice' reforms.[936] However, this could mean that transitional strategies may in some cases run counter to established dogma on the operation of the state. For instance, the transitional strategy of 'hybrid enforcement' relies on an administrative agency that has been granted full judicial powers, which breaches the traditional separation of powers that is typical of modern democracies.

In order to understand how transitional strategies can be deployed in the service of capital market development in Latin America, it is essential to identify the major issues that these strategies must tackle. To this end, the discussions in the previous Section

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mechanisms that are thereby introduced. Moreover, in the context of transitional economies, 'transitional institutions' have been described as those 'institutions that fit the initial conditions of transition and that will support market reforms, while building political support and preventing a macroeconomic output fall'. See G Roland (2000) 194.

936 Id.

highlighted three issues that must be taken into consideration when designing transitional strategies for the region.

The first major issue concerns the dominance of family business groups in Latin American capital markets, which provides solutions to a number of shortcomings across the region, but also exacerbates a set of problems that could potentially slow down economic growth. Defusing this tension ideally requires strategies that, on the one hand, preserve the multiple benefits of groups while, on the other hand, reduce the excessive extraction of private benefits of control in this setting.[937]

The second major issue concerns the difficulties faced by standalone firms that seek to access capital markets in Latin America. The weakness of the infrastructure that supports enforcement makes it difficult for both standalone firms and family business groups to rely on the state as the main supplier of the assurances required by investors to overcome adverse selection. At the same time, family business groups may have a considerable advantage over standalone firms in the use of reputational intermediation to provide these same assurances to investors. As a result, standalone firms often have a hard time competing with family business groups for equity resources in Latin American capital markets. Addressing this issue requires strategies that improve the ability of standalone firms to supply the assurances required by investors.

A third major issue concerns the political economy problems described earlier. The dominance of family business groups in the region makes it highly likely that they will be able to frustrate any reform efforts that seek to address the previous two issues.

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937 KJ Hopt and K Pistor, Company Groups in Transition Economies: A Case for Regulatory Intervention?, (2001) 2 EUROP BUS ORG L REV 1 ('the challenge for policymakers is therefore to balance the short-term benefits with the potential long-term costs of company groups') 15.

Also, the dominant influence of the *grupos* increases the likelihood of regulatory capture, as few regulators will be willing to act against these business groups.

The following discussions explore the potential impact of transitional strategies with regard to each of these interrelated issues.

B. Informal enforcement for *grupos*

The available literature on business groups shows how these structures were successfully dismantled in the US during the first decades of the 20th century.[938] In Latin America, however, the *grupos* have proved to be solidly resilient against any attempts to curb their dominance.[939] Even if one reached the conclusion that dismantling the *grupos* was a sound policy objective, perhaps the only way of accomplishing this goal would be through gradual, long-term reforms.[940] In any case, following the discussions above, it is not entirely clear that a policy of dismantling the *grupos* would be recommendable in the short term. This is due, of course, to the reliance of Latin American economies on the advantages tied to the existence of these business groups.

If one accepts that dismantling the *grupos* is not feasible or even recommendable in the short term, a reasonable course of action would be to ameliorate the problems posed by their dominance in Latin American capital markets. For this purpose, in line with the explanations made in the previous Chapters, it is necessary to analyse how formal and informal institutions could potentially deal with the downsides associated with the *grupos*.

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938 For an account of how US utilities groups were dismantled, see SA Bank and BR Cheffins (2010).

939 BR Schneider (2008).

940 Id.

It seems clear that effective formal institutions would have the potential to constrain the behaviour of insiders in Latin American family business groups. The different types of legal measures studied in Chapter III (i.e. bans, self-enforcing rules and ex post reviews) embody sophisticated mechanisms that can in fact limit self-dealing in the context of capital markets. It is important to bear in mind, however, that choosing between each type of rule entails important trade-offs. The trade-offs studied here relate to the discretion granted to corporate actors, the costs borne by policymakers and the actual probability that the rule will be applied in practice. Understanding the relation between these elements is an essential first step to gauge the effects that legal measures would have with respect to the *grupos*.

In Latin American nations, where the state infrastructure that supports formal enforcement is generally weak, a straightforward ban on certain types of self-dealing transaction (i.e. loans to affiliates) may have a high chance of being applied in practice. Nevertheless, bans would be detrimental to the operation of family business groups, as they may disrupt the close business relations between group affiliates that give rise to the 'internal market' benefits mentioned earlier.

A policymaker who is aware of this issue—and who recognizes the importance of the *grupos* to economic activity in Latin America—could instead decide to rely on a system of ex post reviews to determine the fairness of transactions between group affiliates. One potential approach would be to introduce special rules for corporate groups, as in the case of Germany and France.[941] In these countries, ex post reviews work on the basis of statutory law (i.e. the *Konzernrecht* in Germany) and judicial precedent

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941 See L Enriques and others (2009); KJ Hopt and K Pistor (2001).

(the *Rosenblum doctrine* in France) in order to regulate the actions of the insiders in control of a business group. Another potential approach would be to rely on a system of fiduciary duties to review transactions between group affiliates.[942]

Any of these systems of ex post reviews would preserve the group's internal market benefits by allowing all intra-group transactions to go forward. At the same time, these systems would create a sort of sieve for singling out unfair transactions that should be reversed or for which insiders could be held liable. Of course, the problem with any system of ex post reviews in Latin America is that it has little chance of being used in practice.

Latin American countries lack the infrastructure required to support a system of this nature, particularly as it concerns adjudicators with expertise in corporate matters.[943] This observation leads to the main reason for which the codified system of corporate fiduciary duties and derivative litigation that exists in many Latin American countries remains largely unused: The lack of the essential infrastructure on which this system must be rooted if it is to be effective.[944] In fact, even remedies that are ostensibly more compatible with local legal systems, such as the abuse of rights and good faith doctrines, are scarcely applied to the complexities of corporate action.

Our hypothetical policymaker, also aware of these problems, would then turn to self-enforcing rules as a means to control the consumption of private benefits in listed

942 KJ Hopt and K Pistor (2001).

943 C Paz-Arez, Directors' Duties and Directors' Liabilities: A Framework for Law Reform in Latin America (2002) OECD Corporate Governance Roundtable Paper, available at http://www.oecd.org/dataoecd/1/0/2085788.pdf

944 K Pistor and C Xu develop a similar argument in the context of transition economies. See Fiduciary duty in transitional civil law jurisdictions: Lessons from the incomplete law theory (2002) ECGI Law Working Paper No. 1.

firms. This approach has been employed with some success in the UK, where a strong emphasis on the exercise of shareholder rights has produced positive results.[945] In the Latin American context, self-enforcing rules that, for instance, granted a majority of non-conflicted shareholders the power to veto related party transactions would force controlling shareholders to negotiate with minority investors before such transactions could take place. Assuming that minority investors will not abuse their bargaining power in order to unfairly hold-up controlling shareholders, a self-enforcing rule of this nature might strike a good balance between the trade-offs discussed earlier. Many Latin American countries in fact use procedural requirements of this nature to tackle self-dealing in listed firms.[946]

A self-enforcing rule of the nature described above could even be adapted to fit the context of business groups. In practice, granting minority shareholders a veto right over related party transactions in this context might significantly obstruct the groups' activities, particularly when these investors hold shares in a group subsidiary instead of the main holding company. As transactions between affiliates are part of the ordinary course of business within a group, calling a shareholders' meeting to analyse every conflicted transaction is an unrealistic prospect. Moreover, coordinated minority shareholders of subsidiaries that control key points of a group's supply chain (i.e.

945 The success of this approach may be due to the appreciable influence of institutional investors over UK firms. See J Armour (2008) (examining the importance of 'informal private enforcement through the exercise of shareholders' governance entitlements' in the UK, where these entitlements 'derive efficacy from the high proportion of shares held by institutional investors, who are relatively sophisticated repeat players in the corporate governance arena').

946 F Reyes (2008).

transportation) could potentially block transactions that are essential to the operation of the whole group unless they are granted some sort of compensation.[947]

To avoid problems like these, a modified version of the self-enforcing rule analysed here might bestow the right to approve related party transactions on the board and, more specifically, on non-conflicted directors. A rule of this nature would simultaneously grant a measure of protection to minority investors and preserve the group's ability to transact business. However, as explained in Chapter III, the dominant influence of majority shareholders over the board's composition makes for deferential directors who cater to the interests of insiders. This seems to be the case across Latin America, where a recent OECD survey suggested that directors generally lack independence from controlling shareholders and almost never discuss conflict of interest transactions.[948]

It follows that the formal institutions currently in place in Latin America may be insufficient, on their own, to fully regulate the behaviour of insiders in business groups. For this reason, it seems appropriate to discuss the possibility that informal institutions may have a hand in dealing with insiders in the *grupos*.

Chapter IV explored the idea that reputational intermediation, an informal institution, might exert some influence over the behaviour of insiders in emerging

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947 This assumes, of course, that minority investors are not only able to overcome coordination problems but are also active and sophisticated enough to act in the manner described above. Even so, the group might solve the problem in this example by *not* having minority investors in subsidiaries that control key parts of the group's supply chain. In fact, groups that restrict outside investors to the main holding company could deal with this issue as well as with the problem of having to call upon shareholders to review every conflicted transaction, as explained above. However, the insiders of these groups also have important financial incentives to list several of the group's subsidiaries and form pyramidal structure.

948 OECD, Achieving Effective Boards: A Comparative Study of Corporate Governance Frameworks and Board Practices in Argentina, Brazil, Chile, Colombia, Mexico, Panama and Peru, 2011.

countries. Reputational intermediation is thought to have been of some importance during the initial development of capital markets in industrialized countries, where it supported exchange through informal relations of trust. The analysis presented above, which focused on how the insiders of the *grupos* could act as reputational intermediaries, suggests that this informal institution may be capable of playing a similar role in modern developing countries.

Latin America arguably meets some of the preconditions required for reputational intermediation by the insiders of family business groups to take place. This does not necessarily mean, however, that reputational intermediation actually performs the role described here. To be sure, the idea that controlling shareholders can act as reputational intermediaries in capital markets has received almost no attention from empirical scholars. One of the few available studies that could support this claim considers only a small sample of firms in Sweden, where local conditions differ significantly from those found in Latin American countries.[949]

Moreover, even if controlling shareholders did behave in the way described earlier, this still would not mean that reputational intermediation would necessarily be an effective tool against self-dealing in emerging countries. Since reputational intermediation ties an insider's wealth to her observable behaviour, the whole system rests on the availability of clear and indisputable information about the actions of controlling shareholders. Meeting this requirement calls for the presence of an agency with official authority that centralizes the production and circulation of information concerning the behaviour of these insiders, an activity that can be best accomplished

949 See A Jansson and U Larrson-Olaison, Heard It Through the Grapevine: Reputational Control of European Business Groups with a Controlling Shareholder, Linnaeus University Working Paper, available at http://snee.org/filer/papers/642.pdf. See also R Masulis and others (2012).

through the intercession of formal institutions.[950] Absent this centralized mechanism, the firm's counterparties would have to judge the behaviour of controlling shareholders based on individual and potentially conflicting interpretations of publicly available information.[951] Furthermore, without this centralized mechanism for the dissemination of credible information, controlling shareholders may mislead investors into believing that they are being treated fairly, as explained more thoroughly in Chapter V. For these reasons, reputational intermediation may also be insufficient, on its own, to deal with adverse selection in developing capital markets.

It follows that, when examined independently from each other, both formal and informal institutions may fall short in setting a limit to self-dealing by the controlling shareholders of Latin American *grupos*. However, the limited scope of this analysis does not reflect important interactions such as that described in Chapter V, where formal institutions reinforce the operation of informal institutions. It seems therefore necessary to consider the potential complementarity that arises when a centralized agency employs a system of rules as a means to enhance reputational intermediation in capital markets. This can be accomplished through the informal enforcement strategy of 'naming and shaming'.[952]

A strategy of informal enforcement at the hands of a centralized agency—based, for instance, on the compliance with strict disclosure requirements and a limited set of rules—may be particularly effective in the context of Latin American *grupos*. In fact, this strategy may be a cheaper and relatively faster option than engaging in major institutional

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950 See Chapter V. See also J Armour (2008).

951 J Armour (2008).

952 See Chapter V.

reforms meant to improve the framework that supports formal enforcement in the region. Crucially, informal enforcement would preserve the benefits tied to the existence of the *grupos*, whilst at the same time reducing the chances of excessive consumption of private benefits.

Informal enforcement based on strict disclosure requirements would not only facilitate the operation of the reputational mechanism, but may also contribute to reveal the complete structure of *grupos*.[953] Although the identity of *grupo* insiders is usually well known, there is a significant data gap concerning the full array of firms subject to the control of these individuals. This lack of information can be used to hide self-dealing transactions from the public, a problem that could be mitigated through the informal enforcement of disclosure obligations.

Informal enforcement may also have potential in Latin America due to the value that the *grupos* place on their reputational capital.[954] Reputational effects—which sustain informal enforcement—are at their strongest when parties interact repeatedly in an environment without significant formal enforcement.[955] This seems to be the case of the

953 Timely disclosed, high quality data about listed firms increases the confidence of investors, facilitates the marketing of shares and contributes to the growth of secondary trading markets. The success of equity markets in developed nations has even been attributed largely to the fact that listed firms can make 'a credible commitment to high quality, comprehensive disclosure for an indefinite period into the future' (see EB Rock, 'Securities Regulation as a Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure' (2002) 23 CARDOZO L REV 675). SM Davidoff, 'Regulating Listings in a Global Market' (2007) 86 N Carolina L Rev 89, 161

954 T Nenova, 'A Corporate Governance Agenda for Developing Countries' (2005) Contaduría y Administración 181.

955 DA Skeel, 'Corporate Shaming Revisited: An Essay for Bill Klein' (2005) 2 Berkeley BUS L J 105, 117. Naming and shaming can be particularly useful in Latin America due to the absence of alternative disciplining mechanisms for rogue insiders.B Liebman and C Milhaupt, 'Reputational Sanctions in China's Securities Market', Columbia Law and Economics Working Paper No. 318/2008 http://ssrn.com/abstract=999698.

grupos, which have continuous dealings with multiple outside counterparties in product and capital markets.[956]

Grupos that are known for unfair dealing (i.e. those that consume excessive private benefits) will bear high costs in reputation-based trading.[957] These costs come from adverse changes in the conditions under which the group's counterparties will be willing to deal with it in future interactions. The loss of reputation also has an effect on the group's cost of capital, as *grupo* affiliates will find it more costly to raise external funds, reduce leverage or shed firm-specific risk through future share offerings. Informal enforcement actions might even capture the attention of unaffiliated media outlets, which would amplify the reputational damage to the group.[958] In addition, as explained in Chapter IV, the financial costs of negative reputational effects could potentially spread across all the listed and non-listed firms that belong to a *grupo*.

The potential advantages tied to informal enforcement lead to the question of who could play the part of the centralized agency for the production and dissemination of credible information about group affiliates. The discussions below suggest that regulators may be best placed to assume this role in the Latin American countries examined here. This is due to their proven effectiveness, as compared to local judiciaries and SROs, as well as to the possibility of reducing the likelihood of regulatory capture through the

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956 The presence of a family at the helm of the group may extend the number of these prospective interactions almost indefinitely. It must be noted, however, that the prevalence of corporate groups can reduce the need of firms to engage in reputation-based trading. In fact, any dealings between companies within a same group will depend mainly on the will of the group's controlling party and not on repeated interactions facilitated by reputation. Still, there is sufficient scope for reputation based trading in capital markets and in industries in which a corporate group has no active presence.

957 JM Karpoff, DS Lee and GS Martin (2008) (n 151) 582.

958 On the importance of the media as a constraint on private benefit extraction, see A Dyck, N Volchkova and L Zingales, 'The Corporate Governance Role of the Media: Evidence from Russia' (2006) 63 J FIN 1093, 1135.

cross-border coordination of enforcement policies within the Latin American Integrated Market (MILA).[959]

C. Hybrid enforcement for standalone firms

As mentioned earlier, Latin American standalone firms (i.e. those not affiliated with *grupos* or the state) must find a way to provide credible assurances to outside investors. Although formal institutions can be used to this effect, the lack of the essential requirements for ex post reviews to operate effectively limits the effectiveness of a system of this nature. It must also be noted that, even with a centralized mechanism for the production and dissemination of information, informal institutions may not be of much service to standalone firms. In fact, standalone firms with no previous reputation would find it hard to compete for equity resources against incumbent firms with ties to Latin American *grupos*.

For the foregoing reasons, it seems appropriate to analyse the use of bans and self-enforcing rules to control the behaviour of insiders in standalone firms, as a means to create the space for credible assurances to be furnished to investors. Despite the many advantages of bans and self-enforcing rules, the Russian experience with the Law on Joint-Stock Companies calls for some caution. As explained in Chapter III, the application of any kind of rule—even those of a nominally self-enforcing nature—presupposes at least a 'decent legal and enforcement infrastructure'.[960] This requires not only a set of rules designed to match the context in which they are deployed but, more

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959 For a discussion concerning the potential role that SROs might play in Latin American capital markets, as well as the problems associated with their intervention, see R Gilson, H Hansmann and M Pargendler (2010).

960 B Black, R Kraakman and A Tarassova (2000).

importantly, a responsive external authority that can intervene when necessary to update the rules and punish deliberate attempts to circumvent them.

Even the most carefully drafted rules may rapidly become ineffectual as entrepreneurs react strategically to their introduction. An illustrative example concerns the liability of general partners under the limited partnership form available across most Latin American countries (the *sociedad en comandita*). On paper, general partners are liable for the unpaid debts of a limited partnership.[961] In practice, the nominal general partners are often undercapitalized companies with full limited liability. Although this manoeuvre may be perfectly legal prima facie, the individuals that truly act as general partners—who are fully shielded from liability for the debts of the limited partnership—could use this structure to defraud the firm's creditors. Of course, this problem exists outside of Latin America, where it is often dealt with through mechanisms that require some sort of judicial review (i.e. shadow directors, abuse of rights, piercing the veil).

Bans and self-enforcing rules are not exempt from this problem. A restriction imposed on self-dealing transactions of a certain nature (i.e. asset tunnelling) will lead insiders to engage in transactions not covered by the restriction (i.e. cash flow or equity tunnelling). Much more worryingly, however, even if this restriction covers all relevant self-dealing transactions, the lack of a responsive external authority gives ground to the subset of insiders that use complex corporate structures to circumvent the law. Individuals willing to follow this path can simply hide behind offshore companies to

961 This system of liability is similar across all the jurisdictions that adopted this business form derived from the medieval *commenda*.

engage in self-dealing without triggering the protections set up for outside investors.[962] Considering that even authorities in the most developed countries have trouble detecting this strategy, it is easy to see how illegality of this nature might spread through emerging countries.

Despite these problems, the main insight here is not that formal institutions are useless because individuals willing and able to bypass the law will find ways to do it. Instead, the message that must be drawn from this analysis is that, since effective formal institutions require the constant intervention of an external authority, it is important to expend efforts towards this end.

When corporate insiders know that misbehaviour will be met with swift action by an external authority, wrongdoers will have incentives to behave within the confines of the applicable system of rules. However, enforcement by external authorities usually runs against several hurdles in Latin America. Judges lack the technical expertise required to deal with corporate matters and are mostly relied upon for executive collection proceedings. Regulators, who may have the resources and the expertise required to this effect, are sensitive to political pressure from influential insiders, which may delay or put a stop to prospective enforcement actions.[963]

Addressing these problems through major reforms is bound to be a costly and lengthy process, fraught with political obstacles. However, certain intermediate solutions might accomplish the goal of creating a responsive and independent external authority.

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[962] For a full report on these practices in the context of fraudulent activities, see E van der Does de Willebois and others, The Puppet Masters: How the Corrupt Use Legal Structures to Hide Stolen Assets and What to Do About it, (2011) World Bank: Stolen Asset Recovery Initiative.

[963] JC Coffee (2007) 244.

One potential avenue to accomplish this goal may involve empowering a regulator to take on the role of the external authority described here. An example of this approach may be found in Australia, where the Securities and Investment Commission has ample support to engage in public enforcement, a task it pursues actively through civil, criminal and administrative proceedings against corporate insiders.[964] To this effect, it must be noted that some Latin American regulators have sufficient human and capital resources to take on the role of the external authority described here. Table 4 summarizes the main attributes of regulators in a selection of Latin American countries, including Brazil, Chile, Colombia and Peru.

However, even these well-equipped agencies may be subject to capture in a manner similar to that of financial regulators in developed jurisdictions. A way to deal with this problem may be to institute a system of 'hybrid enforcement' that combines elements of public and private enforcement.

Hybrid enforcement, as understood here, consists of granting full judicial powers to specialized regulators in order to deal with corporate conflicts between insiders and outside investors. Enforcement of this nature would combine the resources and the expertise of specialized regulators with the ability of litigating parties to propel a judicial process. The reliance on specialized regulators would ensure that the external authority had the means to deal with complex corporate affairs. At the same time, the availability of a judicial process would mitigate the prospect of regulatory capture, to the extent that

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[964] Id.

the regulator would find it difficult to abort or substantially delay a judicial action submitted by an outside investor.[965]

Table 4
Latin American Regulators

	Brazil	Chile	Colombia	Peru
Name of regulator	CVM	SVS	SFC	CONASEV
Budget 2008 (US$ M)	$90.67	$16.69	$58.25	$8.6
Employees (2009)	500	262	732	142
Enforcement staff	30	10	28	N/A
% of total staff used for enforcement	6%	3.8%	3.8%	N/A

Source: *Latin American Corporate Governance Roundtable (2011)*

The Colombian experience with hybrid enforcement through the Superintendence of Companies, an agency that specializes in corporate law, suggests that this solution may hold some promise. The Superintendence regulates closely-held firms with the purpose of protecting 'the interests of shareholders and other stakeholders from potential abuses carried out in business corporations'.[966] Over the years, this agency developed what some authors call a body of administrative jurisprudence, made up of written opinions compiled in books published periodically by the Superintendence.[967] This administrative

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965 Of course, since enforcement of this nature infringes on the separation of powers that is characteristic of modern democracies, strict controls must be set in place in order to prevent abuses. One could think of an appeals process before a high-ranking tribunal or, when available, the use of constitutional remedies such as the writ of *amparo* available across Latin America. KE Davis and MJ Trebilcock (2008).

966 F Reyes (2008).

967 Id.

jurisprudence, which has been compared to the no-action letters issued by the American SEC, guides lawyers and entrepreneurs as to the finer points of corporate law.[968]

Starting in 1998 and triggered by the perceived ineffectiveness of the Colombian judiciary, the Superintendence was granted judicial powers to deal with corporate conflicts.[969] Although these powers were initially restricted to a few highly specific issues, the agency's ability to intervene in corporate conflicts was greatly expanded in 2008 and 2012.[970] Since then, the Superintendence has acted as a specialised corporate judge through its Department of Judicial Enforcement, crafting decisions with technical precision in a reasonable time span. The following figures track the Superintendence's judicial activity in the context of corporate conflicts over the past 5 years. Figure 10 shows the average length of a judicial process carried out before the Superintendence, based on a sample of 37 decisions. Figure 11 describes the main issues brought before the agency, based on this same sample.

As shown below, more than 80% of the Superintendence's judicial activity has been focused on challenges to decisions rendered by shareholders' assemblies. These challenges usually relate to the breach of the rules that govern voting majorities or the legal formalities established for the operation of a meeting of the shareholders. It is important to note that the average length of a process carried out before the Superintendence is 14 months, whereas an executive collection process initiated before the local judiciary takes an average of 42 months.[971]

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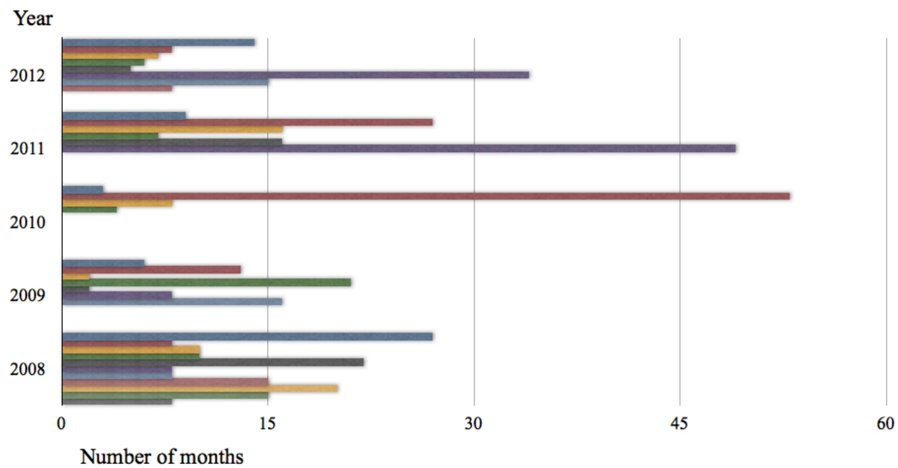
968 Id.

969 See Sections 133 to 138 of Colombian Law 446 of 1998.

970 See Law 1258 of 1998 and 1450 of 2011.

971 See Doing Business Report 2012, available at www.doingbusiness.org

Figure 10
Average length of judicial processes before the Superintendence



Source: Hand-collected data from the archives of the Superintendence of Companies

Moreover, the quality of the judicial decisions rendered by the agency often reflects the technical knowledge accumulated by the Superintendence over the years. In a recent decision, for instance, the agency decided against a shareholder plaintiff that sought to invalidate a decision to amend the by-laws in order to supress the pre-emption rights of shareholders.[972] To reach its conclusion, the agency undertook a meticulous analysis of the legal rules that govern pre-emption rights in Colombia, as well as of the provisions contained in the by-laws to this effect and the relations between the different shareholders. In another case, the Superintendence sought to review a share issuance made with the apparent purpose of diluting the equity share of a foreign company in a Colombian corporation.[973]

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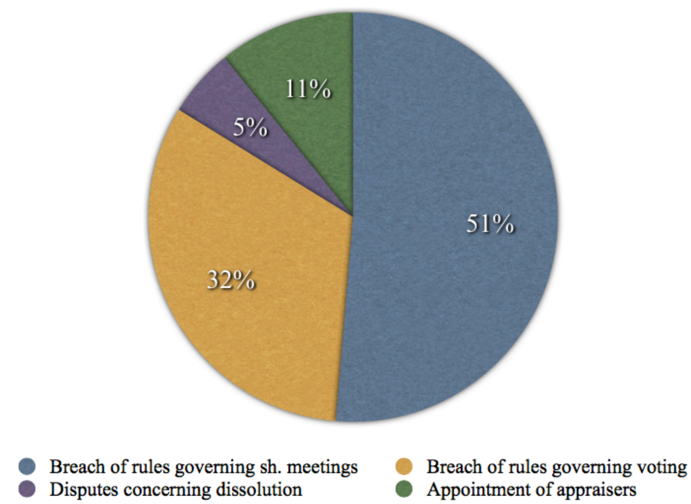
972 CM Gomez vs Promotora La Alborada S.A. (August 12, 2012), available at www.supersociedades.gov.co

973 Capital Airports Holding Company vs CAH Colombia S.A., available at www.supersociedades.gov.co

Figure 11
Main issues brought before the Superintendence



Source: Hand-collected data from the archives of the Superintendence of Companies

Crucially, the system of hybrid enforcement administered by the Superintendence may limit the prospect of regulatory capture. In fact, once a judicial complaint has been brought before the agency, the Superintendence's head of judicial enforcement—who for all purposes acts as a judge—must admit it, provided that the lawsuit meets the corresponding legal requirements. As with any other judicial process, the parties put forward relevant evidence, submit the motions they consider appropriate and are generally charged with propelling the process. For this reason, the Superintendence is limited in its ability to delay or dismiss a given complaint, as might happen if the agency came under pressure from influential parties in the course of exercising its powers as a regulator. The prospect of capture is further reduced in light of the Colombian appeals system, under which the Superintendence's decisions may be subject to review by a Tribunal in a limited number of cases. The country's Constitutional Court also preserves the ability review, under an expedited process, every one of the Superintendence's judicial decisions.[974]

Despite its multiple advantages, the system operated by the Colombian Superintendence of Companies has several problems. For instance, although hybrid enforcement reduces the prospect of regulatory capture, this problem still persists. This is mainly due to the rules that govern the appointment of the officers in charge of the agency. To this effect, the President of Colombia directly appoints the *Superintendente*, who acts as the head of the agency, and may replace this officer without cause. Since the *Superintendente* also appoints the head of the Department of Judicial Enforcement and may remove this officer without cause, it is at least theoretically possible for influential outsiders to exert pressure on the judge charged with reviewing a corporate conflict.

Moreover, local procedural law is replete with formalities, which has created numerous obstacles that slow down judicial proceedings. Local lawyers have become experts at using these formalities to delay litigation. Also, since litigation levels in corporate affairs have been traditionally low, Colombia does not have an active plaintiff's bar for these matters. This has an impact on the total number of cases brought before the Superintendence, as well as on the quality of corporate litigation in the country. Finally, since lawyers and entrepreneurs have always avoided corporate litigation due to the deficiencies of the country's judicial system, they have reservations about using the Superintendence for complex corporate matters.

[974] The Constitutional Court may decide to review judicial decisions rendered by the Superintendence whenever the *tutela*, a special remedy designed to protect constitutional rights, is used to challenge one of those decisions. Since the Colombian Constitution has almost 400 articles, the parties to a judicial process have ample space to challenge unfair or abusive decisions issued by the agency.

Overall, however, the Superintendence provides a measure of enforcement for closely-held firms in a system in which the local judiciary is inadequate to deal with corporate matters. This method of hybrid enforcement through specialized regulators may be replicated across Latin America, where specialized regulators are commonplace.[975] The prospect of swift enforcement by an external authority could allow standalone firms to provide the credible assurances discussed earlier. Nevertheless, if a transitional strategy of this nature is to function properly, the system of hybrid enforcement must be carefully designed.

The Colombian Financial Superintendence, which acts as the country's securities regulator, provides a telling example of the difficulties of setting up a system of hybrid enforcement. This entity also has judicial powers to prevent the abuse of minority shareholders as well as the resources to act as a specialised corporate judge. However, legal ambiguities and difficulties in the process of bringing lawsuits before this entity have prevented shareholders from using this judicial avenue more than a few times over the past decade.

C. Regulatory dualism and political economy problems

The notion of regulatory dualism, as used here, follows the findings of a group of scholars who suggested that this strategy could help overcome political economy problems.[976] Simply put, the idea relates to the introduction of a legal regime into which firms can voluntarily opt and that coexists with the rules that govern the operation of incumbents. This strategy creates an option for those firms that decide to adhere to the

975 See Table 4, above, for a list of the regulators that could fulfil this role across Latin America.

976 R Gilson, H Hansmann and M Pargendler (2010).

new rules. At the same time, it helps overcome the resistance of interest groups to institutional reform, as the old system of rules is kept in place. In the context analysed in this Chapter, the purpose of the new system would be to set enforceable limits to the behaviour of corporate insiders, so that standalone firms that opt into the new regime can provide the credible assurances required by investors.

One way of introducing the new regime mentioned above requires the use of specialized market venues that operate in parallel to regular or main lists within stock exchanges. These tiers usually function under rules that differ from the general framework that governs listed firms in a particular jurisdiction.[977] Under a strategy of regulatory dualism, specialized market tiers could potentially sustain a legal system in miniature, much like the parallel regime operated by the NYSE during the age of the robber barons. In Latin America, standalone firms that intend to overcome adverse selection could self-select into these venues, which would allow them to supply investors with the credible assurances described earlier.[978]

However, not every market venue is up to the task described above. To be sure, there are many potential types of specialized tiers. For instance, stock exchanges in Continental Europe have experimented widely with the design of these venues.[979] During

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977 This is possible due to the self-regulatory nature of certain stock exchanges. S Gadinis and HE Jackson (2007).

978 The successful use of specialized market tiers in this manner can potentially increase the number of individuals and firms that invest in shares issued by listed firms. As the number of investors in listed firms grows, this constituency would expand its sphere of influence and lobby local governments for reform of investor protection rules. This could defeat the resistance of traditional pressure groups that oppose welfare-enhancing reforms in order to protect their rent-seeking activities. This pattern of market forces leading to an enlarged pool of investors that ultimately seek legal reform can be observed in the history of capital markets in the US (JC Coffee (2001b) and the UK (BR Cheffins (2003) 19).

979 See R Abbanat, 'Feasibility Study: A Pan-European Market for Technology Growth Companies' (2004) MIT-EASDAQ http://www.europabio.org/documents/MIT-Full.pdf.

the 1990's, the so-called New Markets were set up in several Member States to provide European firms with better listing options in their home countries.[980] These venues adopted strict disclosure and governance requirements, which arguably supplied firms with a local bonding option meant to emulate the effects of cross-listing into the US. The demise of the New Markets after the .dot com bubble burst led European stock exchanges to follow a more flexible approach to regulation.[981] New listing venues were launched in several Member States, with varying degrees of success. The model for these new venues was the AIM tier, discussed in Chapter V, which follows a flexible regulatory model that caters to firms that intend to go public without bearing the full listing expenses of LSE's Main List.

It must be noted that the AIM model does not seem to match the needs of Latin American standalone firms. As explained in Chapter V, this model works on the basis of a complex system that requires a sophisticated pool of investors, close oversight by stock exchanges and a large enough group of financial institutions that can act as reputational intermediaries (i.e. the Nominated Advisers). Regulatory dualism of the kind described above is more closely related to the existence of an actual parallel legal regime that can limit the excessive consumption of private benefits.

Perhaps the closest example of a specialized market tier that meets the needs of Latin American standalone firms is Brazil's Novo Mercado. The São Paulo Stock Exchange ('Bovespa') of Brazil launched this tier, the first of its kind in Latin America,

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[980] S Weber and E Posner, 'Creating a Pan-European Equity Market: The Origins of EASDAQ' (2000) 7 REV INT POLIT ECONOMY 529, 573.

[981] JM Mendoza (2008).

in 2000.[982] At the time, local stock exchanges were failing due to a crisis of confidence amongst investors and an almost complete lack of IPOs and secondary offerings by Brazilian firms.[983] The Novo Mercado was meant to counteract the lack of investor confidence in equity markets by setting a high entry bar for listed firms. Issuers that seek access to this special segment have to comply with stringent mandatory rules designed to increase transparency and improve the rights of minority shareholders.[984] Firms that adhere to these rules could potentially overcome adverse selection and reduce their cost of capital.

The results of the Novo Mercado over the past decade show a decidedly positive response by Brazilian market participants. Records indeed show that, since its creation, over 100 companies have listed in this special segment of BOVESPA.[985] Between 2001 and 2011, Novo Mercado IPOs accounted for 74% of all IPO activity in BOVESPA.[986] For these reasons, the Novo Mercado has caught the attention of commentators who propose its approach as a pathway to stock market development in emerging economies.[987]

The Novo Mercado experience offers several insights that are relevant for the issues discussed here. First, the Novo Mercado shows how a strategy of regulatory

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982 Specialized market tiers have been set up in South Africa (1984, 1989, 2003), Singapore (1987), Turkey (1995), Thailand (2001), Malaysia (2002), Cyprus (2004), China (2004), India (2005), Poland (2007), and Costa Rica (2008). See Grant Thornton, Global Growth Markets Guide (2008) http://www.gti.org.

983 MH Santana and others (2008).

984 Id.

985 RJ Gilson, H Hansmann and M Pargendler (2010).

986 See P Pellini, Stock exchanges as an engine for corporate improvements, OECD (30 November 2011) http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/49287485.pdf

987 E Gorga, 'Changing the Paradigm of Stock Ownership: From Concentrated Towards Dispersed Ownership? Evidence From Brazil and Consequences for Emerging Countries' http://ssrn.com/abstract=1121037, 37.

dualism can offset the resistance of interest groups in the context of developing stock markets.[988] Instead of promoting legal reforms to introduce new rules for all listed firms, an initiative that would have surely been opposed by local interest groups, BOVESPA managed to set up a novel legal regime through the Novo Mercado. The parallel regime has mostly benefited new firms, who have been the main users of this market tier.[989]

Second, despite its success, the Novo Mercado has been unable to deal with the enforcement problems that are typical of Latin America and other emerging regions. Firms listed in this tier must adhere to a mandatory arbitration clause, which allocates any corporate conflicts to BOVESPA's Market Arbitration Panel. However, the Panel has not been used once since the creation of the Novo Mercado in 2000. This may be due, of course, to the existence of alternative means to discipline insiders in the Novo Mercado, including the intervention of the local regulator (the *Comissão de Valores Mobiliários*), which often enters into settlement agreements (*Termos de Compromisso*) with corporate insiders.[990]

Another potential explanation concerns the intervention of BOVESPA, which can penalize firms that breach Novo Mercado requirements. BOVESPA has become increasingly active in the exercise of these powers, with 10 Novo Mercado firms fined in 2009, 12 in 2010 and 30 in 2011.[991] These fines mostly concern late submissions of disclosure reports, particularly those that must be presented in English, and the failure to update the 'Annual Corporate Calendar', which sets out the dates in which disclosure

988 RJ Gilson, H Hansmann and M Pargendler (2010).

989 For an in-depth analysis of regulatory dualism in the context of the Novo Mercado, see Id.

990 For a list of settlement agreements entered into between listed firms and the CVM, see www.cvm.gov.br

991 For a list of the fines imposed by BOVESPA on Novo Mercado firms, see http://www.bmfbovespa.com.br/cias-listadas/consultas/notificacoes-e-multas-aplicadas.aspx

reports will be filed with BOVESPA and the dates for the meetings of corporate organs.[992]

The lack of activity on the Market Arbitration Panel may also be due to the cost of arbitration, which could deter investors from using this mechanism. It is also possible, however, that investors 'may simply have recognized a lost cause when they saw one'.[993] This enforcement deficiency is important in light of the evidence that points to some degree of self-dealing in the Novo Mercado.[994]

Third, some of the rules adopted by the Novo Mercado may not be effective in achieving their stated purpose. This would be the case, for instance, of the one share, one vote rule enforced by the Novo Mercado. This rule is important to the extent its application is the main difference between the thriving Novo Mercado and the much less successful Level 2 market tier.[995] As mentioned in Chapter III, the ultimate purpose of the one share, one vote rule is to reduce the incentives of controlling shareholders to expropriate minority investors.[996] The Novo Mercado version of the rule is enforced through limitations on the issuance of non-voting and multiple voting shares.[997]

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992 For the information on the nature of these fines, see Id. A description of the contents of the Annual Corporate Calendar is available at http://www.bmfbovespa.com.br/en-us/markets/download/regulamento.pdf

993 RJ Gilson, H Hansmann and M Pargendler (2010).

994 A di Miceli, V Muller and R Sasso, Related party transactions: Legal strategies and associations with corporate governance and firm value in Brazil, Centro de Estudos em Governança Corporativa Working Paper No. 002, 2009.

995 As of July 2012, the Level 2 segment had only 19 listed firms, whilst the Novo Mercado had close to 130. See http://www.bmfbovespa.com.br/cias-listadas/Empresas-Listadas/

996 By tying the voting power of shareholders to their economic stakes in listed firms, this rule seeks to prevent the severe misalignment of incentives generated by disproportional control. For relevant discussions, see JM Mendoza (2012).

997 See the Novo Mercado rules available at www.bmfbovespa.com.br/en-us/markets/equities/.

One share, one vote rules such as the one adopted by the Novo Mercado have been criticized on many grounds.[998] Perhaps the most salient critique is that these restrictions are mostly ineffective.[999] The availability of pyramids, cross-holding structures, derivative products and shareholder coalitions renders any ban on disproportional ownership useless.[1000] There is some evidence that Novo Mercado firms have resorted to these mechanisms in order to circumvent the one share, one vote rule.

One example concerns Springs Global Participações S.A., a firm in the textile manufacturing business.[1001] While Companhia Tecidos Norte de Minas (Coteminas), a firm listed in the regular BOVESPA segment, controls 68.4% of the common shares issued by Springs Global Participações S.A, a local family holds a 51.4% voting stake in Coteminas.[1002] This pyramidal structure allows this family to exercise full voting control over Springs Global Participações S.A. despite being entitled to only 35.2% of its cash flow rights.[1003] This is not the only known case of controlling shareholders circumventing the Novo Mercado's one share, one vote rule.[1004]

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998 A Kalay and S Pant (2009); M Belcredi and L Caprio (2004).

999 G Psarakis (2008); A Kalay and S Pant (2009).

1000 G Ferrarini (2006) 174; K Rydqvist (1992) 55.

1001 For information on this company, see http://www.bmfbovespa.com.br/cias-listadas/Empresas-Listadas/ResumoEmpresaPrincipal.aspx?codigoCvm=20966&idioma=en-us

1002 A di Miceli, Seven Mistakes: Part II, (2009) 6 CAPITAL ABERTO 72.

1003 Id.

1004 Id.

Chapter VII

The Latin American Integrated Market

1. The development of capital markets in Latin America

Despite the increased pace of growth Latin American stock exchanges experienced over the last decade, local capital markets are less developed than expected in light of the region's economic fundamentals.[1005] Finance in Latin America is still mostly bank-oriented and relationship-based, an arrangement that traditionally matched the needs of economies in the region. However, for the reasons explained in this dissertation, rapid economic development is straining the ability of Latin American financial systems to match local demand. In fact, although the region's banking industry continues to provide essential financial services, there is a growing need for a more balanced financial system that supports higher levels of market-based exchange.

Meeting this demand is no easy task. As documented by the available literature, Latin American capital markets face numerous challenges. One significant challenge has to do with the size and depth of the region's capital markets.[1006] Studies have shown that liquidity levels are lower in Latin American markets than in those that operate across the emerging regions of Eastern Asia.[1007] This problem is made worse by the buy-and-hold strategies of some institutional investors and the inclination of the largest firms in the

1005 A de la Torre and others (2012).

1006 Id.

1007 AD Hales, The Role of Liquidity in Price Discovery of American Depositary Receipts: Evidence from Latin America (2012) Working Paper available at www.aeaweb.org/aea/2012conference/program/

region to issue equity in more developed exchanges outside Latin America.[1008] Additionally, as explained in Chapter VI, stock exchanges in the region show high levels of concentration.[1009] For example, Colombia's *Bolsa de Valores*, the fastest-growing exchange in the region, has less than 80 listed firms, most of which are controlled by a handful of families or the local government.[1010] Also, despite a recent increase in the number of IPOs, the total number of equity issues remains low across Latin America.[1011]

Although these size and depth deficiencies can reduce the interest of Latin American firms to raise equity resources locally, perhaps the major challenge facing the region has to do with the dominance of the *grupos*, family-controlled business groups with considerable political and economic influence. To be sure, for the reasons set out in Chapter VI, the *grupos* are central to economic activity in Latin America. However, the *grupos* have also created significant barriers to the development of capital markets in the region. The influential insiders in control of the *grupos* can thwart enforcement actions by regulators and block any efforts at improving the regulatory and enforcement infrastructure of Latin American capital markets.[1012]

A faulty regulatory framework and incomplete enforcement have made it difficult for firms to rely on the state-backed legal system as a means to supply credible commitments to investors. It follows that many firms have a hard time dealing with the

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[1008] See A de la Torre and others (2012) 107 (describing some of the factors that may explain the liquidity issues of Latin American stock exchanges). See also Peru's Capital Market Scarcely Liquid, FINANCIAL TIMES (March 19, 2013).

[1009] See also A de la Torre and others (2012) 111.

[1010] Data available at http://www.bvc.com.co/pps/tibco/portalbvc/Home/Empresas/Listado+de+Emisores.

[1011] See Chapter VI.

[1012] Chapter VI explained how this political economy problem probably led in the past to the failure of serious reform efforts, as the influence of the *grupos* in local circles allowed them to block welfare-enhancing reforms that could reduce their rents.

acute adverse selection problem that was described in previous Chapters. As a result, access to the region's stock exchanges has been reserved mostly for companies controlled by the *grupos*, as they can provide credible commitments to investors without relying on the state-backed system.[1013] Without an overhaul of the institutions that support the state-backed system, standalone firms will only have limited access to local stock exchanges and the *grupos* will continue to be the main players in capital markets. Since the *grupos* can effectively block institutional reform, further capital market development may seem implausible.

This final Chapter starts by tracking some of the ways in which an ongoing process of integration between Latin American stock exchanges can contribute to overcome the challenges described above. The Latin American Integrated Market (or MILA, after its acronym in Spanish), which currently groups the stock exchanges of Chile, Colombia and Peru—with Mexico scheduled to join later this year—can help deal with the problems of scale mentioned earlier and could also potentially insulate Latin American policymakers and regulators from the pressure exerted by the *grupos*. The last part of the Chapter builds on earlier discussions to analyse potential regulatory reforms that could help mitigate the problem of adverse selection in the region's capital markets.

2. The Latin American Integrated Market

The Latin American Integrated Market (MILA) was launched in 2011 with an opening ceremony that took place simultaneously across three countries. MILA currently groups

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[1013] As explained in Chapter VI, the ability of group insiders to leverage their reputational capital grants them privileged access to the region's capital markets, but also crowds out standalone firms that cannot rely to a similar extent on reputation to provide the assurances required by outside investors.

over 560 listed companies with a total market capitalization of $660 billion.[1014] The MILA project started in 2008 with negotiations between exchange officials from Colombia and Peru, with the Chilean *Bolsa de Comercio de Santiago* joining the discussion in 2009.[1015] Soon after, officers from these three countries met to discuss the regulatory changes required to enable the integration of their respective stock exchanges. Initially designed to operate as a joint trading platform, MILA was scheduled to become a consolidated multi-jurisdiction exchange by the end of 2013. Although complete consolidation has been delayed, the integration of the Chilean, Colombian and Peruvian stock exchanges has picked up pace over the past three years.

The launching of MILA marked the start of a new chapter in the history of Latin American capital markets. As shown in Table 5, MILA already has more listed firms than Brazil's BOVESPA and approximately half of its market capitalisation. The forthcoming addition of the *Bolsa Mexicana de Valores* and rumours that BOVESPA might soon join the integrated market could turn MILA into a major international market.[1016]

Table 5

Aggregate data for MILA (December 2012)

	Peru BVL	**Colombia BVC**	**Chile BCS**	**MILA (without Mexico)**	**MILA (with Mexico)**	**Brazil BOVESPA**
Market cap (US billions)	103	262	313	678	1.203	1.227

1014 A Oppenheimer, South American stock exchange: The way to go, MIAMI HERALD (16 February 2011); The Benefits of MILA: Three Latin American stock exchanges unite, KNOWLEDGE WHARTON (17 November 2010).

1015 M Seraylan, 'La integración de mercados y depositarios centrales: Experiencia del MILA' in Estudio sobre los sistemas de registro, compensación y liquidación de valores en Iberoamérica (Instituto Iberoamericano de Mercados de Valores 2011) (Spanish only).

1016 A Thompson, Mexico to join LatAm Exchange tie-up, FINANCIAL TIMES (6 December 2011). See also BOVESPA Enters Talks to Join MILA, BUSINESS NEWS AMERICAS (13 April 2013).

Number of issuers	214	76	245	515	646	353
Traded volumes (US billions)	6	40	46	92	218	875
Number of intermediaries	25	27	32	84	118	90

Adapted from Bolsa de Valores de Colombia, Progress Report (2012).

One of the reasons behind the creation of MILA was to promote deeper capital markets in Latin America.[1017] To this effect, commentators suggest that the integrated exchange's expanding size may bring the region closer to the goal of improving liquidity and revitalizing IPO markets.[1018] In fact, a recent analysis of Latin America's main economies found that the creation of MILA could potentially 'increase market liquidity and the spectrum of investible assets'.[1019] During the initial stages of integration, with MILA operating as a cross-border trading platform, it is expected that shared order routing, greater regional access and cross-membership will enhance liquidity across the Chilean, Colombian, and Peruvian stock exchanges, a process that will pick up pace after the Mexican Stock Exchange joins MILA later this year and the exchanges consolidate their integration within the new market.[1020] There is in fact evidence that stock exchange consolidation can have a positive effect on liquidity.[1021] Improved liquidity, along with a

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1017 The Pacific Alliance: A New Latin American Superpower, MONEYWEEK (2 April 2013).

1018 See A Thompson (2011). See also MILA: A new phase of integration in Latin America, LATAM ALTERNATIVES, available at http://latamalternatives.com/Files/MEDIA_PRESS_1.pdf

1019 IMF Country Report No. 13/45, February 2013.

1020 LSE Targets Latin American Business Through Peru Deal, BANKING TECHNOLOGY (18 January 2013). 'Mexico's *Bolsa Mexicana de Valores* has recently ratified its commitment to join (MILA), subject to regulatory and legal authorisation' (Bourses: Uniting to Build Critical Mass, FINANCIAL TIMES (November 13 2012).

1021 For instance, a recent study of Euronext found that the structure of this multi-jurisdiction market was tied to 'improved liquidity and accounting quality'. G Pownall and others, Increasing Liquidity on Global Stock Exchanges: The Structure of Euronext (2012), correlated reduction in the cost of capital and enhanced capital market efficiency, may attract new firms to MILA.[1022]

Aside from the benefits described above, MILA may have a significant impact on the regulation and supervision of listed firms in Latin America. First, the creation of MILA has increased the prospects for regulatory alignment between Chile, Colombia and Peru, with convergence on Chile's higher disclosure and governance standards being a likely scenario. Second, MILA has pushed regulators towards a tight coordination of enforcement policies at the regional level, which has already led to the creation of supranational bodies such as the Supervisory Committee and the Executive Committee of Regulators. Finally, the increasing reallocation of authority from the local to the regional level could potentially dilute the ability of the *grupos* to influence policymakers and regulators. These ideas are developed below.

A. Regulatory convergence

Despite the degree of formal legal convergence brought about by the OECD's old reform programme, there are still important regulatory differences between Chile, Colombia and Peru. Of all three MILA countries, Chile undoubtedly has the highest disclosure and governance standards.[1023] Chile's ongoing regulatory reform efforts have been driven by a host of factors, including the pressure exerted by institutional investors

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http://ssrn.com/abstract=1800384. Although merger attempts between MILA members have been scuttled in the past, the Chilean, Colombian, and Peruvian exchanges are moving rapidly towards consolidating their operations.

1022 For an explanation of the link between liquidity and cost of capital, see Y Amihud and H Mendelson, The Liquidity Route to a Lower Cost of Capital (2000) 12 J APP CORP FIN 4.

1023 For a historic overview of Chilean capital market regulation, see R Cifuentes and others, Capital Markets in Chile: From Financial Repression to Financial Deepening (2002) Central Bank of Chile Economic Policy Paper No. 4.

and corporate scandals such as the *Chispas* case. The *Chispas* scandal arose as a result of a 1997 takeover of a local listed firm (Enersis S.A.) by a Spanish energy company (Endesa S.A.), during which several of the former company's directors were found to have incurred in a conflict of interest.[1024] In the years following the scandal, Chile introduced Law 19.705 of 2000, with stringent rules on tender offers and transactions that involve conflicts of interest.[1025] Chilean policymakers followed up on these efforts with three major reforms, introduced through Laws 19.768 and 19.769 of 2001 (also known as capital market reform I or 'MKI'), Law 20.190 of 2007 (MKII) and Law 20.448 of 2010 (MKIII).

This ongoing process of regulatory fine-tuning has resulted in high standards for Chilean listed firms. For instance, although *grupos* are prominent in Chile's stock markets, there is some transparency concerning the ownership structure of business groups and transactions between affiliates.[1026] This situation stands in contrast to the other MILA countries, where even the largest *grupos* can still conceal their full ownership structures through cross-holdings and pyramidal structures.[1027] In Colombia, for example, the latest capital market reform focused more on mainstream corporate

1024 T Wigodski (2008).

1025 Superintendencia de Valores y Seguros, Desarrollo de las Tomas de Control Corporativo en Chile Despues de la Ley de OPAs, (2004) available at http://www.svs.cl/sitio/publicaciones/doc/informe_serie_doc_trab4.pdf. A more recent scandal, involving a local retailer (La Polar), has for the moment only led to fines against the firm's officers and a backlash by pension funds (AFPs) against PriceWaterhouseCoopers. See Chilean AFPs Consider Switching Auditors in the Wake of the Case of La Polar, Funds Americas (February 17, 2012).

1026 D Buchuk and others, The Internal Capital Markets of Pyramidal Business Groups: Evidence from Chile (2012) available at www.finance.uc.cl/economia_puc/images/stories/FinanceUC/conferences/ third/Larrain2012.pdf

1027 In Colombia, for instance, the officers of a major business group have stated in securities filings that the *grupo* has no controlling shareholder. At the same time, however, the CEO of the group's holding company disclosed to a local press outlet that the *grupo*'s majority shareholders had no intention of relinquishing control. The fact that local authorities have not followed up on this contradiction could perhaps be seen as a sign of *grupo* influence in the region.

governance provisions—rules on precatory board proposals, audit committees and internal control systems—than on basic disclosure of ownership structures.[1028] To boot, Colombia introduced a corporate governance code for listed firms, apparently modelled after the UK's Combined Code on Corporate Governance, which got the 'comply or explain' methodology almost exactly backwards. Colombian listed firms had to identify the recommendations that they had adopted and explain the manner in which compliance was accomplished, instead of explaining why they had not complied with other relevant provisions set out in the Code.[1029] Although this issue was subsequently fixed, almost no listed firm in Colombia complies with the Code's recommendations regarding the disclosure of related party transactions.[1030]

Despite the regulatory differences mentioned above, the onset of MILA has set Chile, Colombia and Peru on a path towards convergence. This is due not only to the stated intention of policymakers to ensure that firms listed on the integrated market are subject to a homogenous set of rules, but also to MILA's internal agreements, which compel harmonization of capital market regulation. Policymakers from the three MILA countries have already started meeting on a regular basis to study proposed changes to their national legislations, with the ultimate goal of '[advancing] towards regional regulation'.[1031] In particular, there is some expectation that the new integrated exchange

1028 See Chapter VI.

1029 E Molina, Corporate Governance and Firm Valuation in Colombia: Are We Heading in the Right Direction? (2012) (draft on file with author).

1030 See 2011 Report on Compliance with the Countrywide Corporate Governance Code, available at http://www.superfinanciera.gov.co/Codigopais/informeanual.htm (Spanish only).

1031 MILA: Strengthening Financial Integration (2012) Inter-American Development Bank, available at http://www.iadb.org/en/topics/trade/mila-strengthening-financial-integration,6839.html. See also Los Supervisores del MILA Calibran Temas Regulatorios, PORTAFOLIO (28 April 2013), available at http://www.portafolio.co/economia/los-supervisores-del-mila-calibran-temas-regulatorios (Spanish only).

will help promote convergence between MILA countries with regard to the regulation of related party transactions for listed firms.[1032]

The process of regulatory convergence described above has been hastened by the creation of the Pacific Alliance, a trading bloc made up of Chile, Colombia, Mexico and Peru.[1033] The Alliance, currently the largest economic bloc in Latin America, grew out of negotiations between the three MILA countries and Mexico, which culminated in the Pacific Alliance Treaty of June 2012.[1034] Although the countries that form part of the Pacific Alliance have adopted numerous measures to facilitate cross-border exchange,[1035] including the reduction of trading tariffs and the lifting of visa requirements, MILA is widely considered to be the centrepiece of the new trading bloc.[1036] One of the Alliance's stated goals, as noted in the Joint Statement of the Presidents of the Pacific Alliance, is to strengthen the movement 'of services and capital' by procuring the integration of stock exchanges between the member nations.[1037] At a recent summit, the Treasury Secretaries

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1032 OECD, Latin American Report on Related Party Transactions (2012b), available at http://www.oecd.org/daf/ca/LatinAmericanReportonRelatedPartyTransactions.pdf

1033 The Growing Pacific Alliance: Join the Club, ECONOMIST (29 April 2013).

1034 Pacific Alliance Launched in Chile, ICTSD (13 June 2012). The Pacific Alliance is on its way to becoming the largest economic bloc in Latin America. In fact, 'the four economies have a total combined value of $872 billion, compared to $543 billion for Mercosur. Their combined exports also far exceed those of Mercosur, with $443 billion against $282 billion'. C Salazar, Chile, Colombia, Mexico and Peru in economic alliance, AP (28 April 2011).

1035 By the end of 2013, all trading tariffs between the Alliance countries will have disappeared. See Pacific Alliance Further Establishes Itself, INFOSUR (17 April 2013) available at http://infosurhoy.com/cocoon/saii/xhtml/en_GB/features/saii/features/economy/2013/04/17/feature-01

1036 The Pacific Alliance itself is considered by some to have been a by-product of MILA's creation. See J Ponce, The Context and Implications of the Formation of the Pacific Alliance for U.S. Foreign Policy (2012) available at http://www.academia.edu/2966590/The_Context_and_Implications_of_the_Formation_of_the_Pacific_Alliance_for_U.S._Foreign_Policy

1037 Joint Presidential Statement of Lima (April 28, 2011), available at http://embamex.sre.gob.mx/guatemala/images/stories/PDFs/DeclaracionPresidencialAlianzaPacifico.pdf (Spanish only).

of all four current members of the Alliance restated their commitment to ensure regulatory convergence in capital markets.[1038] The budding internal structure of the Pacific Alliance, which gathers top officers from each of the four member countries, could facilitate legislative action to reach this goal.[1039]

Recent developments in Peru and Colombia suggest that both countries might already be moving towards improved capital market standards. For example, Peru has embarked on its first major capital market reform in over a decade.[1040] As stated by Peruvian officials, the reform is aimed at improving transparency levels for listed firms and to facilitate overall access to equity finance.[1041] The Peruvian reform also seeks to enhance the ability of local institutional investors, particularly private pension funds, to invest in capital markets.[1042] Moreover, after a recent meeting of MILA policymakers, the head of Colombia's financial regulator announced that the country had started working on a major overhaul of capital market rules.[1043] The reform's key areas include reviewing

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[1038] Países de la Alianza del Pacífico evaluaron medidas conjuntas para fortalecer integración económico-financiera, Peruvian Finance Ministry (25 April 2013) (Spanish only).

[1039] It must be noted, however, that regulatory coordination within economic blocs can also face numerous problems, as exemplified by the long process of corporate law harmonization within the European Union. See L Enriques, Company Law Harmonization Reconsidered: What Role for the EC? (2005) ECGI Working Paper No. 53.

[1040] Peru Unveils Capital Market Reform, EMERGING MARKETS (March 17, 2013), available at http://www.emergingmarkets.org/Article/3171653/Peru-unveils-capital-market-reform.html

[1041] Peru Espera que Reforma del Mercado de Capitales Potencie su PIB, LA PRENSA (December 4, 2012), available at http://www.prensa.com/uhora/economia/peru-espera-que-reforma-de-mercado-de-capitales-potencie-su-pib/141783. See also Reforma Busca Incorporar Nuevos Emisores, PROCAPITALES (30 October 2012), available at http://www.procapitales.org/web/secciones/notas_detalle.php?nropag=1&idnota=15 (Spanish only). Reform efforts in Peru are also geared towards improving competition and increasing liquidity. See Peru Capital Markets Reforms Seen in First Half of 2013, WALL STREET JOURNAL (8 February 2013).

[1042] Peru Congress to Debate Capital Market Reform Next Month, BLOOMBERG (20 July 2012).

[1043] Los Supervisores del MILA Calibran Temas Regulatorios, PORTAFOLIO (28 April 2013), available at http://www.portafolio.co/economia/los-supervisores-del-mila-calibran-temas-regulatorios (Spanish only).

governance standards for listed firms, enhancing supervision over *grupos*, and allowing institutional investors to have a more active participation in capital markets.[1044] A recent scandal, which saw the country's largest broker-dealer, Interbolsa, collapse amid accusations of fraud, has moved capital reform to the top of the policy agenda.[1045]

Although regulatory convergence between Chile, Colombia and Peru is rapidly becoming a reality, the ultimate outcome of this process is still uncertain. Despite early signs that Colombia and Peru are improving their framework of capital market rules, the political economy obstacles described earlier might hinder effective reforms, as it has already happened in the past. However, for the reasons explained further below, the coordination of regulatory initiatives through regional bodies might contribute to mitigate these political economy problems.

B. Regional coordination of enforcement policies

Aside from the pressures towards regulatory convergence, the onset of MILA has led to the increasing coordination of enforcement policies at the regional level. Over the past three years, the regulators of Chile, Colombia and Peru have entered into a series of agreements that set out a comprehensive framework for the joint supervision of the integrated market. Although these agreements were initially meant to facilitate cross-border cooperation, there has been a noticeable shift towards the creation of regional institutions charged with the oversight of MILA.

1044 Esta es la Ruta que Tomará el Mercado de Valores, DINERO (17 May 2013), available at http://www.dinero.com/inversionistas/articulo/esta-ruta-tomara-mercado-valores/175938 (Spanish only).

1045 See Lawmaker Accuses Interbolsa of Money Laundering, REUTERS (9 May 2013).

On January 15, 2010, the regulators of Chile, Colombia and Peru entered into a memorandum of understanding with the stated purpose of laying out channels for the exchange of information and facilitating the enforcement of securities regulation through mechanisms labelled 'requests for assistance'.[1046] According to the text of the MOU, the agreement between the three regulators was intended to facilitate the integration of capital markets.[1047] To this effect, the MOU expressly mentioned areas of interest such as insider trading, IPOs and secondary offerings, related party transactions, and the operation of clearing houses, broker-dealers and other intermediaries. More importantly, the agreement set out a commitment for MILA regulators to engage each other in an ongoing dialogue meant to improve the enforcement of capital market rules.[1048]

The initial commitments of MILA regulators were strengthened in June 2011, through the execution of the First Addendum to the 2010 MOU.[1049] Aside from widening the scope of cooperation between MILA regulators, the 2011 agreement set up the first regional body charged with coordinating joint supervision and enforcement activities within MILA.[1050] The creation of the Supervisory Committee, a regional organ that

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1046 See Memorandum of Understanding executed between *Superintendencia de Valores y Seguros*, *Superintendencia Financiera* and *Superintendencia del Mercado de Valores del Perú*, available at http://www.superfinanciera.gov.co/NuestraSuperintendencia/memoperuchile2010.pdf(Spanish only). An earlier Memorandum of Understanding, dated October 28, 2009, set out abstract commitments to 'facilitate the project of integrating the capital markets of the three countries'.

1047 See Section 2 of the 2010 MOU.

1048 Under Section 2.1.8 of the 2010 MOU, MILA regulators committed to 'engage each other periodically to discuss (…) potential improvements to their operations and deal with issues that may arise from time to time in the course of supervising capital markets'. It must also be noted that, as per Sections 2.1.2 and 3.3, the 2010 MOU did not create binding obligations but rather a commitment for cooperation.

1049 See First Addendum to the Memorandum of Understanding, available at http://www.superfinanciera.gov.co/NuestraSuperintendencia/memoperuchile2010adenda1.pdf (Spanish only).

1050 B Ross, Successful integration of exchanges in Chile, Colombia and Peru, FIX GLOBAL TRADING (15 September 2011).

assembles top officers from the regulators of each country, may have laid the foundations for the future delegation of enforcement powers from local to regional authorities. In fact, the Supervisory Committee was granted the power to (i) design rules to facilitate the exchange of information and enforcement within MILA, (ii) coordinate joint enforcement actions between MILA regulators and (iii) set up task forces charged with the design of supervision and enforcement policies for the integrated market.[1051] After the creation of the Supervisory Committee, policymakers from Chile, Colombia and Peru have met periodically to share their experiences with the regulation of listed firms and to discuss the design of policies for the joint supervision of MILA.

In 2012, the head regulators of Chile, Colombia and Peru met again to execute the Second Addendum to the 2010 MOU.[1052] The language included in this new Addendum signalled a clear intention to lodge enforcement authority—as well as the design of regulatory initiatives—at the regional level, as exemplified by the 'harmonization of policies' and 'joint design of objectives' to which MILA regulators were directed in the agreement. The Second Addendum created yet another regional body for the coordination of supervision and enforcement within MILA. The Executive Committee of Regulators gathers the heads of the Chilean *Superintendencia de Valores y Seguros*, the Colombian *Superintendencia Financiera* and the Peruvian *Superintendencia del Mercado de Valores* with the purpose of allowing for 'top-level coordination […] with the ultimate goal of

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1051 It is also relevant to note that Section 3 of the 2011 Addendum refers to the joint intervention of regulators in response to detected breaches of capital market rules in any of the three MILA countries.

1052 See Second Addendum to the Memorandum of Understanding, available at http://www.superfinanciera.gov.co/NuestraSuperintendencia/memoperuchile2010adenda2.pdf (Spanish only).

strengthening the process of integration between the three markets'.[1053] For this purpose, the Executive Committee of Regulators can (i) set out regulatory policies for MILA, (ii) allocate resources to execute policy items with a short to mid-term time horizon, and (iii) approve guidelines and joint policies for supervision.

Although similar in nature to the extinct European Committee of European Securities Regulators, the Executive Committee of Regulators is starting to resemble a centralized supervisory agency, along the lines of the European Securities and Market Authority. To this effect, the Executive Committee already has the power to lead joint enforcement actions across borders. The Executive Committee of Regulators has also started to channel the unified positions of MILA policymakers and regulators. After a recent meeting, the members of the Executive Committee of Regulators spoke publicly about capital market reform, the ongoing integration between the three countries and the possible admission of Mexico to MILA.[1054]

A quick review of the 2010 MOU and its subsequent Addenda reveals how the creation of MILA has moved regulators towards the increasing coordination of regulatory and enforcement policies at the regional level. The next subsection takes measure of the potential impact of this reallocation of authority with regard to the political economy obstacles identified in Chapter VI.

1053 See Section 3 of the Second Addendum.

1054 See Los Supervisores del MILA Calibran Temas Regulatorios, PORTAFOLIO (28 April 2013), available at http://www.portafolio.co/economia/los-supervisores-del-mila-calibran-temas-regulatorios (Spanish only).

C. The political economy benefits of MILA

As mentioned earlier, Latin American *grupos* pose a significant challenge to the region's capital markets. A unique combination of abilities—high organizational capabilities, the power to exert influence through their dominance of various industries, close links with the political elite, and the capacity to engage in long-term relations with politicians and policymakers—grants the *grupos* considerable sway in their home jurisdictions. Through their influence over regulators and politicians, the *grupos* are often able to thwart enforcement actions and block efforts to introduce effective institutional reforms. The dominance of the *grupos* has led commentators to conclude that any significant improvements to Latin America's institutional infrastructure should be seen as a long-term, incremental prospect.[1055]

Despite the problems described above, the integration of stock exchanges within MILA could potentially speed up the process of institutional reform. The idea here is that the reallocation of authority from the local to the regional level can insulate policymakers and regulators from the influence of the *grupos*.[1056] Under the theory of *collusive delegation*, the allocation of authority to a supranational body allows officers from the executive branch to form a sort of policy cartel with their counterparts from other countries, 'permitting them to loosen domestic constraints imposed by legislatures, interest groups, and other societal actors'.[1057] In other words, the concerted transfer of

1055 See, for instance, BR Schneider (2008) 390. See also Chapter VI.

1056 As recorded in the available literature, the delegation of powers to supranational authorities often serves to shield local officers from the pressure exerted by domestic interest groups. See S Meunier, Trading Voices: The European Union in International Commercial Negotiations (2005, Princeton University Press) and A Moravcsik, Why the European Union Strengthens the State: Domestic Politics and International Cooperation (1994) Harvard Center for European Studies Working Paper No. 52, available at http://aei.pitt.edu/9151/1/Moravcsik52.pdf

1057 A Moravcsik (1994) 1.

authority to regional bodies enhances the autonomy of policymakers by shielding them from domestic pressures.[1058]

The idea of collusive delegation has been associated with the allocation of authority for trade negotiations within the European Union.[1059] By lodging the power to conduct trade agreements at the EU level, policymakers can direct negotiations with non-EU countries without being subject to protectionist pressures from local interest groups in each Member State.[1060] In fact, as the centralized authority in charge of the EU's trading policies, the European Commission can 'easily fend off lobbying from sector interests in one or only a couple of Member States'.[1061] Commentators argue that this delegation of authority to the Commission might have facilitated trade liberalization in the EU.[1062] Examples of collusive delegation may also be found in the EU's foreign, security and monetary policies.[1063]

In the field of capital markets, collusive delegation might have taken place in the EU through the transfer of legislative power that enabled the implementation of

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[1058] M Koenig-Archibugi, The Democratic Deficit of EU Foreign and Security Policy, (2002) 4 THE INTERNATIONAL SPECTATOR 62, 63. See also S Meunier (2005).

[1059] 'The decision of the founding member states of the European Community to delegate trade negotiating authority to the supranational level can similarly be explained by this willingness to insulate international trade agreements from protectionist pressures'. See S Meunier (2005) 9.

[1060] See S Meunier (2005) and A Moravcsik (1994).

[1061] S Woolcock, European Union Trade Policy: Domestic Institutions and Systemic Factors (2005, Kelly, D. and Grant, W., (eds.) The Politics of International Trade in the Twenty-First Century: Actors, Issues and Regional Dynamics, International political economy series, Palgrave, 240).

[1062] 'The autonomy that decision-makers gained as a result of delegation allowed them to implement trade policies that further the public good, that is, achieve trade liberalisation, against the resistance of protectionist forces' (A Dür, Economic Interests and EU Trade Policymaking, (2007) European Union Studies Association Conference Paper, available at http://www.unc.edu/euce/eusa2007/papers/dur-a-09d.pdf).

[1063] M Koenig-Archibugi (2002). See also C De Burca, Democracy and the EU, (2004) http://www.feasta.org/documents/democracy/deburca.htm. However, some authors consider that there is scant empirical evidence to support the idea of collusive delegation in the European Union. See A Dür (2007).

Directives and Regulations. It has been argued that accession to the EU freed policymakers in countries like the Czech Republic from the resistance of entrenched interest groups to capital market reform.[1064] Regulators in European Member States may have also gained some insulation from local interest groups after the creation of the Committee of European Securities Regulators (CESR). Although CESR's powers were limited and it mostly issued non-binding recommendations, this centralized forum for the coordination of EU-wide policies might have provided some cover for regulators against domestic pressures.[1065] The creation of the European Securities and Market Authority, which further lodged enforcement at the EU level, may have enhanced the insulation of Member State regulators from domestic interest groups.[1066]

Potential examples of collusive delegation can also be found outside the EU.[1067] In the case of Japan, for instance, commentators have noted that regulators increased their authority over local banks after joining the Capital Adequacy Accords.[1068] According to Colombatto and Macey, 'Japanese bureaucrats could not obtain the power unilaterally to impose minimum capital requirements on their own banks because Japanese banks were

1064 See D Brenneman, The Role of Regional Integration in the Development of Securities Markets: A Case Study of the EU Accession Process in Hungary and the Czech Republic, available at http://www.law.harvard.edu/faculty/hjackson/alumnipapers/EU_Expansion.Brennaman.pdf

1065 According to Ferran, 'national accountability mechanisms could be threatened by agencies' involvement in CESR—for example, where an agency participates in a CESR decision to develop a controversial new regulatory standard but then clings to the moral high ground of needing to be a "good European partner" to justify imposing that standard in the face of strong, national opposition'. E Ferran, Building a EU Securities Market (2004, Cambridge University Press) 103.

1066 On the creation of ESMA, see AB Spendzharova, Power to the European Supervisory Authorities: Explaining the Incremental Evolution of European Financial Regulation (2012) UACES Conference Paper, available at http://uaces.org/documents/papers/1201/spendzharova.pdf. See also P van Cleynenbreugel, Judicial Protection Against EU Financial Supervisory Authorities in the Wake of Regulatory Reform (2012) 2 ELSA MALTA REV 1.

1067 See, for instance, M Koenig-Archibugi (2002).

1068 Id.

able to resist this attempt'.[1069] After joining the Accords, Japanese regulators gained independence from local banks, a powerful interest group in their jurisdiction.[1070] In fact, forming part of the Accords 'represented a hands-tying strategy in which the Japanese bureaucrats were able to collude with bureaucrats from other countries in order to obtain more discretionary regulatory authority'.[1071]

To sum up, the transfer of authority to a supranational body can serve to erode the influence that interest groups enjoy over regulators and policymakers in their home jurisdictions. The available literature points to some of the channels through which the delegation of authority can provide insulation from local interest groups.[1072] When the power to set the policy agenda is subject to some degree of coordination with supranational counterparties, local policymakers can become regulatory gatekeepers who 'strategically manipulate the timing, sequencing and presentation of policies and issues'.[1073] At the same time, local interest groups that seek to exert pressure at the regional level will face 'high access barriers' that can reduce their ability to effectively influence policy.[1074] The transfer of authority to a regional body also grants policymakers privileged access to information about policy decisions. This can give rise to an

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1069 E Colombatto and JR Macey, A Public Choice Model of International Economic Cooperation and the Decline of the Nation State, (1996) 18 CARDOZO L REV 925, 944.

1070 M Koenig-Archibugi (2002).

1071 E Colombatto and JR Macey (1996) 944.

1072 For a more complete explanation of these 'causal mechanisms', see A Moravcsik (1994) 6.

1073 A Moravcsik (1994) 9. The author points out that it is harder for domestic interest groups to oppose an initiative designed at the supranational level than it would be for them to resist initiatives developed locally (Id., 11).

1074 J Schwatrzkopff, Splendid Isolation? The Influence of Interest Groups on EU Trade Policy, (2009) Berlin Working Paper on European Integration No. 12, available at http://www.gesis.org/sowiport/search/id/iz-solis-90542108. The author notes that the European Commission is somewhat insulated from Member State pressure groups to the extent it does not rely on them on for financial and political support.

asymmetry of information between policymakers and local interest groups that makes it more costly for the latter to influence policy.[1075] Finally, lodging authority at the regional level increases the number of constituencies that vie for influence, which can set competing interest groups at odds with each other and make it difficult for them to coalesce in order to exert pressure on policymakers and regulators.[1076]

Turning now to MILA, it must be noted that, at present, the internal authorities of each individual country retain formal powers to enact capital market regulation and lay out enforcement strategies. However, as explained above, the agreements that underpin MILA have embedded the policy-design process within regional bodies such as the Supervisory Committee and the Executive Committee of Regulators. The mandate to coordinate regulatory initiatives, as set out in the 2010 MOU and its Addenda, amounts in practice to a partial delegation of authority. In fact, under these agreements, the policymakers of one MILA nation could hardly propose changes that were opposed by the two other countries. On the contrary, as in the cases of collusive delegation reviewed above, regulatory initiatives will probably flow from MILA's regional bodies to the legislative authorities of each country.

A similar argument could be made with regard to the design of enforcement policies within MILA. Although the regulator of each country retains formal authority over enforcement, the 2010 MOU and its Addenda call for the joint design of enforcement policies through the Supervisory Committee and the Executive Committee of Regulators. This amounts again to a reallocation of authority from the national to the

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1075 A Moravcsik (1994) 13.

1076 J Schwatrzkopff (2009). Moravcsik also mentions that 'casting a policy as a foreign policy issue augments the executive's ability to craft persuasive ideological justifications'. See A Moravcsik (1994) 14.

regional level. After a specific enforcement strategy has been set at the regional level, national regulators would have few reasons to act against what was agreed, particularly when doing so could constitute a breach of the commitments made for the creation of MILA.

As in the examples of collusive delegation in the EU and Japan, the allocation of authority described above can shield policymakers and regulators from the influence of the *grupos*. First, the mandate to design regulatory initiatives jointly through the Supervisory Committee and the Executive Committee of Regulators may in fact resemble the hands-tying strategy followed by the Japanese regulators that pushed for accession to the Capital Adequacy Accords. By delegating regulatory authority to a regional body, policymakers in Chile, Colombia and Peru will probably have more control over domestic policy agendas. To this effect, the capital market reforms currently being discussed in Colombia and Peru have been framed as necessary to allow for the proper operation of MILA.[1077] In addition, since policy discussions now take place at the regional level, local *grupos* can face information asymmetries that will make it more costly for them to 'distinguish viable alternatives, convince potential supporters of their desirability, bargain internationally over new terms, and draft precise legal language'.[1078]

Second, the creation of the Supervisory Committee and the Executive Committee of Regulators can shield enforcement activities from *grupo* interference. As explained in Chapter VI, public officials in Latin America can hardly commence enforcement actions against a *grupo* without being promptly forced out of office. However, regulators that are seen to act in accordance with the regional commitments set out within MILA can gain

[1077] See Section 1.B above.

[1078] A Moravcsik (1994) 13.

some protection from the *grupos*.[1079] Since there may be a high cost for breaching the commitments with other MILA countries, local officers have a ready-made avenue to resist *grupo* pressures. Moreover, the *grupos* would not gain much by forcing uncooperative individuals out of office, as new appointees would have an equally hard time breaching MILA policies crafted at the regional level.

Of course, the *grupos* could target regulatory and enforcement policies at the regional level. If the *grupos* in each country had similar interests and independently managed to influence the representatives appointed to MILA's internal bodies, the policies set at the regional level could end up reflecting the joint interests of the *grupos*. Nonetheless, even if the *grupos* had compatible interests, exerting influence over MILA policies would still require sophisticated strategies designed to pressure policymakers acting simultaneously at the national and regional levels.[1080] The complexities of this two-level game could make it hard for the *grupos* to individually manipulate regulatory and enforcement policies within MILA.[1081]

1079 A Moravcsik (1994) 8.

1080 In the EU, the transfer of authority to regional bodies gave rise to 'complex multilevel and institutional advocacy coalitions, ad hoc interest groupings, and EU institutionally led forums' in which lobbying requires 'a number of vertical and horizontal strategies. The players must be aware of where a policy is initiated, what the alternative pressure points are, and who has the potential veto points in the process'. D Coen, Environmental and Business Lobbying Alliances in Europe: Learning from Washington? (D Levy and P Newell (eds.), The Business of Global Environmental Governance, 2004, MIT Press) 203.

1081 Reallocating authority to regional authorities could in fact give rise to what Putnam has described as a two-level game: 'at the national level, domestic groups pursue their interests by pressuring the government to adopt favorable policies […]. At the international level, national governments seek to maximize their own ability to satisfy domestic pressures, while minimizing the adverse consequences of foreign developments […]. The unusual complexity of this two-level game is that moves that are rational for a player at one board […] may be impolitic for that same player at the other board'. RD Putnam, Diplomacy and Domestic Politics: The Logic of Two-Level Games (1988) 42 INTERNATIONAL ORGANIZATION 3.

It is also possible for the *grupos* to reinforce their regional influence by forming coalitions that facilitate cross-border coordination.[1082] In fact, the formation of transnational business coalitions is considered to be a natural response to the delegation of authority to regional or international bodies.[1083] Nevertheless, before attempting to exert their influence jointly at the regional level, the *grupos* would have to agree on common areas of interest and design strategies for joint intervention.[1084] For this to happen, however, the grupos would have to overcome potentially significant collective action problems. Although tight coordination at the national level often allows the *grupos* to overcome collective action problems in order to exert pressure over local policymakers, these problems may resurface as the *grupos* are forced to form coalitions with an increasing number of cross-border partners.

The formation of coalitions may also be hindered as a result of the ongoing process of economic integration between Latin American countries—including the Pacific Alliance—which has set the *grupos* in direct competition against each other in product and capital markets.[1085] These competitive pressures can block the formation of

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1082 'Coalitions are helpful to interest groups when groups find it too costly—relative to the benefits of the policy—to lobby alone' K Hebda, Interest group coalitions and information transmission, 2012 Princeton University Working Paper, available at http://www.princeton.edu/politics/about/file-repository/public/Hebda091411.pdf.

1083 A Orsini, Thinking Transnationally, Acting Individually: Business Lobby Coalitions in International Environmental Negotiations, 2011 25 GLOBAL SOCIETY 3. In the years following the creation of CESR in the EU, it was expected that this regional body would 'attract increasing attention from lobbyists […] embracing both indirect lobbying via national governments and direct lobbying of EU institutions. Firms may lobby individually or in coalitions'. E Ferran (2004) 104.

1084 It is relevant to note that, as authority was transferred from Member States to the EU, interest groups representing business 'recognized that to access these restricted entry policy forums, [they] must broaden [their] political and information legitimacy by being more representative of economic and societal interests' D Coen (2004)

1085 One example of the growing competition between Latin American *grupos* involves the Chilean Saieh group, a media and financial conglomerate. The Saieh group recently entered the Colombian market with its financial subsidiary Corpbanca, which set that *grupo* in direct competition with the cross-border coalitions between rival Latin American *grupos*.[1086] Even if *grupos* with competing interests found enough common purpose to coalesce, the expansion of MILA to include countries like Mexico or Brazil could further complicate efforts to jointly influence regulatory and enforcement policies set at the regional level.

3. A new round of reform efforts

Aside from the potential political economy benefits described above, the coordination of regulatory and enforcement policies through MILA has reopened a long-standing debate concerning the operation of capital markets in Latin America. The ongoing dialogue between regional policymakers has in fact set the stage for a serious assessment of Latin America's experience with the regulation of listed firms and, perhaps more importantly, for any course corrections that are deemed necessary.

Even though it is too early to accurately predict the outcome of this new round of reform efforts, some cautious optimism may be warranted. As opposed to previous reforms, under which many Latin American countries blindly followed regulatory agendas designed by supranational organizations, current discussions are focused on proposals developed locally.[1087] These home-grown initiatives have benefited from the recurrent interaction between regional policymakers, a process that MILA has made possible.

local Sarmiento family group, a Colombian conglomerate that also has substantial interests in the media and financial industries.

1086 A Orsini (2011) (the author states that business conflicts can hinder the 'transnationalisation' of business interest groups).

1087 See, for instance, the reforms currently underway in Colombia and Peru, both of which were discussed earlier.

Moreover, the supranational organizations that led the previous and much-criticised reform efforts seem to have reappraised their role in assisting developing countries. A new development plan, the Seoul Development Consensus for Shared Growth, acknowledges the limits of the old grand schemes by advocating international support for local initiatives. The official document produced at the G-20 Seoul Summit of 2010 states that 'there is no "one-size-fits-all" formula for development success and that developing countries must take the lead in designing and implementing development strategies tailored to their individual needs and circumstances".[1088]

Against this backdrop, the OECD has started to conduct country-specific studies that focus primarily on the disclosure of beneficial ownership and related party transactions, as well as on formal and informal enforcement mechanisms. Although the new OECD reports take their cue from old reform efforts, there is a noticeable change of approach.[1089] For instance, a recent study on related party transactions across five Latin American countries—including all three current MILA members—was prepared with the input of local policymakers. The report, which mostly reflects the experience of top officers from the regulatory agencies of Argentina, Brazil, Chile, Colombia, Mexico and Peru, highlights the importance of addressing related party transactions within *grupos*.[1090]

[1088] See Seoul Development Consensus for Shared Growth, (2010), Annex I, available at http://media.seoulsummit.kr/contents/dlobo/E3._ANNEX1.pdf.

[1089] In her assessment of Indonesia, for instance, the drafter of the relevant OECD report states that the goal of the study is to 'support policymakers and regulators in their efforts to enhance disclosure and enforcement of beneficial ownership and control' See OECD, Disclosure of Beneficial Ownership and Control: Policy Options for Indonesia (2012a) http://www.oecd.org/daf/ca/Indonesia DisclosureofBeneficialOwnershipandControl2012.pdf

[1090] See OECD, Latin American Report on Related Party Transactions (2012b) http://www.oecd.org/daf/ ca/LatinAmericanReportonRelatedPartyTransactions.pdf

This explicit recognition of the *grupos* as a main target for regulatory initiatives is certainly a step in the right direction.[1091]

Despite all these positive developments, Latin American policymakers are still struggling to come up with a well-defined framework for the regulation of capital markets. For this to happen, some consensus must be reached in the region as to the top policy priorities that must be pursued. The discussions set out in this dissertation could perhaps assist policymakers in identifying some of the main regulatory priorities for the region's capital markets.

A. Blueprints for reform

A recurring point of this dissertation is that the old OECD-led reforms betray a fundamental misunderstanding about emerging countries in general and Latin America in particular. The state infrastructure in most Latin American countries cannot support the proper enforcement of basic corporate law, much less the complex governance rules introduced in the region over the past decade. For instance, the emphasis that was placed on corporate boards seems misguided when one considers the problem of incomplete enforcement in the presence of controlling shareholders with a commanding influence over directors. Not to mention the fact that, until recently, the role of the *grupos* as the dominant players in the region had been largely ignored.

Similar criticisms have been levelled against the old corporate governance reform agenda in almost every country that followed its prescriptions. More than an assault on that programme, however, this dissertation suggests that a rigorous analysis must be

[1091] Despite the fact that the *grupos* were mentioned as an important issue, the Latin American policymakers gathered at the forum did not go beyond expressing 'interest in continuing to examine the special case of RPTs within groups at the regional level'. See OECD (2012b) 46.

conducted before Latin American policymakers set a policy agenda for the regulation of listed firms. To that end, this dissertation brings some nuance to the discussion concerning some of the problems that must be overcome if capital markets are to take off in the region.

Starting from the idea that outside investors require credible assurances from insiders in order to overcome adverse selection, the previous Chapters explored how formal and informal institutions could be used to that end. The institutions analysed in this dissertation mainly seek to limit the payoffs to controlling shareholders that behave opportunistically. These limits should ideally ensure that the costs that outside investors bear from private benefit extraction do not surpass the benefits that they receive from the value-enhancing activities of controlling shareholders.

Formal institutions, a term used here to describe legal measures and contractual provisions, provide different ways of achieving that goal. This dissertation looked at how bans, self-enforcing rules and ex post reviews could limit the payoffs of controlling shareholders in the way described above. Moreover, an effective system of formal institutions should ideally take measure of the intricacies of Latin American capital markets. For instance, a system of legal rules that failed to take into account the importance of intra-group transactions could erode the internal markets that operate within the *grupos* and that substitute for some shortcomings that are common to Latin America and other developing regions. At the same time, however, a system of ex post reviews designed to accommodate for the presence of business groups has little chance of being used in practice. As discussed in Chapter III, the effectiveness of formal institutions depends on the intervention of an external authority, particularly in the case of ex post reviews. Although courts often fulfil this role in developed countries, judiciaries in Latin America are mostly unable to deal with the complexities of corporate activity.

Reputational intermediation, the main informal institution analysed here, also has problems of its own. Aside from the lack of data regarding the extent of its impact over Latin American firms, reputational intermediation in the region is crippled by the lack of a centralized mechanism for the dissemination of credible information about the behaviour of corporate insiders.

B. Transitional strategies

The discussions on transitional strategies set out in this dissertation can contribute to the design of mechanisms that deal with the problems described above. The starting point for this analysis is the idea that the *grupos* and standalone firms should receive separate treatments. In fact, the policy issues raised by *grupo* structures are substantially different to those associated with standalone firms. With this idea in mind, Chapter VI described how transitional strategies that build on local capabilities could address some of the problems described above.

It was suggested first that informal enforcement techniques might hold some promise in the context of the *grupos*. The state apparatus across Latin American nations is not yet sufficiently strong to support the formal institutions that could simultaneously preserve the internal market benefits of the *grupos* and limit the expropriation of outside shareholders in the manner described earlier. Nevertheless, a strategy of informal enforcement through naming and shaming might go some way towards accomplishing this goal. This option has the added advantage that it does not require substantial changes to the state infrastructure of Latin American nations, but rather the explicit adoption of naming and shaming policies, ideally at the regional level through MILA's internal bodies.

One last point must be made about naming and shaming techniques. Enforcement strategies of this nature should not focus on the compliance with the corporate governance rules introduced as part of the OECD's old reform programme. For the reasons explained in this dissertation, compliance with these rules does not provide real assurances that corporate insiders will deal fairly with investors. If informal enforcement is focused on the compliance of these corporate governance rules, the observable actions of corporate insiders will be directed exclusively towards this end, which would free them to consume private benefits of control at will, as explained in Chapter V. Alternative benchmarks must therefore be sought, taking into account the particular needs of each country. In general, following the explanations made in the previous Chapters, a strong emphasis on disclosure of ownership structures and related party transactions might be desirable.

In the context of standalone firms, it was suggested that hybrid enforcement might facilitate the provision of credible assurances to outside investors. The intervention of a specialised regulator with limited judicial powers may give some force to formal institutions in governing the behaviour of corporate insiders in listed firms.[1092] The

[1092] Although hybrid enforcement is an admittedly unorthodox idea, it has proven to be particularly effective in increasing enforcement intensity in Colombia. Following Roscoe Pound, 'it is the work of lawyers to make the law in action conform to the law in the books, not by futile thundering against popular lawlessness, nor eloquent exhortations to obedience of the writing law, but by making the law in the books such that the law in action can conform to it, and providing a speedy, cheap and efficient legal mode of applying it'. R Pound, Law in the Books and Law in Action, (1910) 44 AMER L REV 23, 36.

resulting increase in enforcement intensity could grant a measure of credibility to the commitment of insiders in standalone firms to deal fairly with outside investors.[1093]

Finally, a strategy of regulatory dualism could complement the transfer of authority to MILA's regional bodies, as a means to overcome the political resistance of the *grupos*. Both Colombia and Peru are currently discussing the possibility of setting up a secondary market tier subject to a specialized legal regime. In both cases, however, policymakers seem to be following the model of London's Alternative Investment Market.[1094] The discussions in Chapters V and VI should caution against transplanting AIM's model to jurisdictions that lack the underlying traits that support AIM's operation (i.e. a large pool of sophisticated investors and a sizeable enough group of financial institutions that can act as Nominated Advisers). It is also unclear how AIM's model could help standalone firms provide the credible assurances required to overcome adverse selection. Despite the problems identified in Chapter VI, Brazil's Novo Mercado might prove to be a more suitable regulatory model for emulation.[1095]

1093 If hybrid enforcement is to provide effective limits to the excessive consumption of private benefits in standalone firms, some care must be employed in the design of the rules set out for these firms. Following the discussions of the previous Chapters, one could think of a system of self-enforcing rules that set out straightforward procedural requirements for the disclosure and approval of conflicted transactions. A specialised regulator with judicial powers would surely be able to swiftly enforce requirements of this nature.

1094 Peru is already poised to launch its 'Alternative Securities Market' (See Almost 180 Companies Could Potentially Enter Peru's Stock Market, ANDINA (October 31, 2012), available at http://www.andina.com.pe/english/noticia-almost-180-companies-could-potentially-enterperusstock-market-434082.aspx; see also Bolsa de Valores para Medianas Empresas Operaría Desde Marzo, GESTION (March 9, 2013), available at http://gestion.pe/economia/bolsa-valores-medianas-empresas-operaria-desde-marzo-2061025 (Spanish only). In Colombia, discussions to launch the secondary market tier are only just starting. See Esta es la Ruta que Tomará el Mercado de Valores, DINERO (17 May 2013), available at http://www.dinero.com/inversionistas/articulo/esta-ruta-tomara-mercado-valores/175938 (Spanish only).

1095 It must be noted that if Brazil's BOVESPA joins MILA, market participants in Chile, Colombia and Peru could gain swift access to the Novo Mercado.

The discussion of transitional strategies presented here is meant to inform the efforts of Latin American policymakers in understanding different approaches to the regulation of listed firms in the region. Although MILA and the burgeoning Pacific Alliance have created the space for serious institutional change, the dearth of independent research in the field of Latin American capital markets could undermine ongoing efforts to introduce effective reform. It follows that much work remains to be done before we have a full understanding of the measures that must be adopted to promote capital market development in Latin America. This dissertation is a small step towards that end.

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