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*How Effective Are
Capital Markets in
Exerting Governance
on Corporations?*

The German government yesterday announced broad voluntary guidelines for publicly traded companies on the management of their businesses, citing the collapse of the US company Enron as a warning sign. . . . Herta Daubler-Gmelin, justice minister, argued that while the code contained no sanctions for non-compliance, “the capital market will provide very effective sanctions” for those that chose to ignore it.

NEWS STORY, *Financial Times*, FEBRUARY 27, 2002

Common rules for corporate takeovers have become a test for Europe’s capacity to reform itself. Thanks to the conservatism of German business and the refusal of the Berlin government to look beyond narrow political interests, it is one that Europe is likely to fail. Despite the eye-catching call for greater disclosure of executive pay, Germany’s new voluntary code, published yesterday, does little to nudge German corporate governance towards a more investor-friendly model.

EDITORIAL, *Financial Times*, FEBRUARY 27, 2002

IT HAS BECOME A truism that the pressures of the capital markets will improve the governance of corporations; equally, that improvements in corporate governance will promote development of the capital markets. However, the relationship of the capital markets to corporate governance is neither simple nor linear; rather, it is more in the nature of a complex feedback loop, a dynamic process responsive to many factors. One of those factors, law, is the delivery mechanism. How effective capital markets are in exerting governance over corporations is in part a function of how effective the legal rules are through which the markets operate.

This paper looks at a set of corporate governance initiatives and innovations driven by capital markets that have been undertaken in emerging markets in recent years and tries to draw some tentative recommendations about their effectiveness. Throughout the paper we examine the dynamic between public legal rules (legislation, regulations, judicial enforcement) and private legal rules (contracting, adherence to voluntary standards, enforcement through arbitration and market discipline) and their relationship to several other factors that have been identified as significant in the development of financial markets. The events of the last fifteen years rival the South Sea Bubble and tulipmania in focusing popular attention on the operations of the capital markets and corporations, for a number of intriguing reasons examined elsewhere. There have been spectacular market surges and market failures, accompanied by a panoply of regulatory and private sector responses. The intensity of the activity and its consequences have raised fundamental questions about how capital markets in particular, and financial systems in general, grow and develop and about the role of corporate actors in that development.

There are still more questions than answers. As Bratton and McCahery wrote in 1999:

In these globalizing times, corporate law's leading question is whether one or another national corporate governance system (or component thereof) possesses relative competitive advantage. . . . Related questions about competitive advantage and convergence to best practice come up in domestic policy discussions in many countries. Concern about local firms' performance in international markets turns attention to alternative governance practices identified in international comparisons: If competitive advantage lies elsewhere, then domestic practice should be reformed to follow the international leader. An extensive body of studies addresses these questions, identifying and

evaluating national variations in management and financial practices, industrial organization, and corporate and securities laws. Unfortunately, even as these descriptions become thicker and more cogent, answers to the bottom-line questions respecting competitive advantage have become more elusive and convergence predictions have become more qualified.¹

With respect to public legal rules, there are some beacons shining through the thicket of discourse, speculation, and experimentation. Legal rules and legal families do matter. Political structures matter. History—they way legal concepts have been introduced—matters. Legal concepts are not indiscriminately interchangeable components of legal systems. Forces of convergence and divergence in legal rules operate selectively.²

La Porta, Lopez-de-Silanes, Shleifer, and Vishny were among the first to turn the spotlight on the relationship of legal rules and development of financial matters: “Because legal origins are highly correlated with the content of the law, and because legal families originated before financial markets had developed, it is unlikely that laws were written primarily in response to market pressures. Rather the legal families appear to shape the legal rules, which in turn influence financial markets. . . . [L]egal rules do matter.”³ In a comprehensive literature review, Bratton and McCahery noted that La Porta and his colleagues looked to the two main legal traditions in developed economies, the Anglo-American common law tradition and the continental European “civil,” or Roman-Germanic, legal tradition, to conclude that the level of legal enforcement and the origin of the legal rules correlated to the level of development of both equity and debt markets. Measures of investor protection appeared superior in common law countries and translated into more vibrant equity markets.⁴

The implication, that common law systems are superior in fostering sophisticated financial systems, was bound to sow controversy and did not go long unchallenged.⁵ Rajan and Zingales were among the first to challenge this view:

1. Bratton and McCahery (1999).

2. On each of these points, see, respectively, La Porta and others (2000); Rajan and Zingales (2001); Pistor (2000), and Pistor and others (YEAR); Bratton and McCahery (1999); and Jordan (2000).

3. La Porta and others (2000, p. 3).

4. Bratton and McCahery (1999).

5. Rajan and Zingales (2001).

First, it does not seem that legal or cultural impediments to financial development are as serious as one might have concluded from recent literature. Somewhat facetiously, one does not have to have the good fortune of being colonized by the British to be able to have vibrant financial markets. However, the main impediment we identify—the political structure within the country—can be as difficult to overcome as more structural impediments. Nevertheless, our second main implication is that to the extent a country can be coaxed to be open, it makes it less easy for domestic incumbents to retard financial development.⁶

Both viewpoints are significant and not necessarily incompatible; each identifies a major determinant in the functioning of financial markets, the legal rules, or more precisely, the legal family or tradition to which they belong, and the political structures that create, support, or possibly undermine them. Legal rules, or more precisely again, public legal rules, are the product of and dependent upon political action.

This debate, and the related one of convergence or divergence in corporate governance systems, caught the eye of Katharina Pistor, then a comparative legal scholar at the Max Planck Institute in Hamburg, who wrote:

There is a lively debate in the corporate governance literature about these alternative patterns of institutional development and in particular about the role of law for convergence or divergence of corporate governance systems. Proponents of the divergence, or path dependence, hypothesis argue that even if the corporate law was harmonized across countries, other legal rules (tax laws codetermination legislation etc.), and institution constraints financial structure existing ownership structure of firms), or simply political considerations would stand in the way of convergence. The opposite view holds that convergence is likely to take place once the main regulatory obstacles are removed. The economic forces towards success, they suggest, are the same all over the world. Both views regard legal institutions as important for promoting or hindering convergence, but differ in their assessment of the propensity of a particular body of law, such as corporate law, to achieve this goal.⁷

6. Rajan and Zingales (2001).

7. Pistor (2000).

Pistor's conclusion: "a simple convergence story does not do justice to the complexity of legal change."⁸

Intrigued by the complexity of legal change, Pistor went on to look at "legal transplants" or the "transplant effect." How do legal concepts from one system fare when transplanted to another? Pistor argued that the manner of transplantation is significant; the extent to which a "foreign" legal concept has been voluntarily introduced or embraced (as opposed to imposed, for political or other reasons), is a predictor of effectiveness, she wrote.⁹

The proliferation of legal transplants has in part been driven by the promotion of "international standards" in both capital markets and corporate governance, an important indicator, it is often held, of convergence of legal rules. International standards have not been picked out of thin air, however; their legal origins can be traced back to national systems, predominantly systems based in common law. Gauging the effectiveness of convergence to these standards becomes a more complex matter.

There is yet another twist to the convergence-divergence debate. The forces of convergence and divergence operate contemporaneously, but selectively, on different kinds of legal rules. Relatively recent statutory law in highly regulated and internationalized areas such as capital markets or banking regulation is sensitive to the forces of convergence. Older, more established bodies of law, statutory or otherwise, are more "path dependent," more resistant to change and absorption of "foreign elements." Corporate or company law, largely a product of the nineteenth century, is an example. The more basic the legal concept, the longer its roots and, arguably, the more impervious it is to the forces of convergence. Concepts of contract, status, and property law, for example, reach back hundreds and thousands of years.

Moreover, legal rules are part of legal systems; legal rules are interdependent within their system. Capital market rules interact with corporate law rules, which themselves are grounded in notions of contract, status, and property. Legal rules that, in theory, should have been effective at one level, could be disabled because of conflicts or incompatibility at another level. Much of the grief that has ensued in the aftermath of the mass privatizations of the 1990s can be attributed to the indiscriminate mixing and matching of legal rules, a process of transplantation that resulted in dysfunctional or

8. Pistor (2000, p. 46).

9. Pistor and others (Year).

imbalanced feedback loops. The corporate governance systems could not support the functioning of the capital markets; nascent or ailing capital markets collapsed or declined; without the disciplines of the capital markets, corporate governance systems did not respond. This is not the whole story, of course, but it is a part of it.

Although the academic work has focused more on public legal rules than on private legal rules, the questions at the heart of the debate apply equally in the context of private rulemaking. Are some systems of private rulemaking superior to others? Are these private systems on a path toward convergence? Is private rulemaking path dependent? How effective can various mechanisms of private rulemaking and enforcement be within the overall system of public and private law? To what extent can private rulemaking mechanisms be imported or transplanted between systems?

Whether one is talking about public or private legal rules, or both, in the end the question is “What works?” Clearly, we are nowhere near the point where we can give definitive answers. Form, however, appears to be as important as substance when it comes to fashioning effective legal rules. And form also appears to be predictive of effectiveness, depending on the legal system in which a rule operates. Different legal traditions demonstrate different preferences for the form that legal rules take.

As the cases that follow illustrate, there has been a blossoming of public and private capital markets initiatives intended to improve corporate governance. Some exciting experiments are under way. One intriguing feature of the Latin American experimentation, in particular, is the way in which of public and private legal rules have been combined and mobilized to create the “quasi” public rules discussed below. But the majority of these efforts did not gather steam until after the Asian financial crisis of 1997. All we can do at this point is to begin to examine such initiatives on a systematic basis and start thinking about what combination of factors are likely to affect the success or failure of the experiments.

Interplay of Public and Private Legal Rules

The debate over the role of legal rules in capital market development and corporate governance systems has focused on public legal rules—legislation (enacted through the political process) and its enforcement through the judicial system. One conundrum noted by Pistor in transition economies, for example, is the co-existence of high-quality formal legislation (in

Pistor's words, a product of "an external supply of legal solutions") and low levels of effectiveness:

Weaknesses in the governance structure that are noted today are often attributed to weaknesses in the law, which in turn leads to new proposals for improving statutory law. The evidence of the quality of the law on the books, however, suggests that this is at best a partial story. The level of shareholder and creditor rights protection in transition economies today is higher than in many other countries. Other factors, including the dynamic of the reform process and its impact on the development of effective institutions to enforce the new law, need to be analyzed more closely to understand the remarkable difference in the governance of firms despite the trend towards convergence of the law on the books.¹⁰

Largely overlooked in this debate, however, is the role of private legal rules, that is, private legal rules established by contract (*ex ante*) and implemented and enforced (*ex post*) by means of various contractual dispute resolution mechanisms, including arbitration, or possibly by market discipline or "reputational hostage-taking."

As an example of the interplay of public and private rules, Professor Frank Partnoy of the University of San Diego recently presented a paper at the Brookings Institution looking at the regulation of the derivatives markets in the United States from this perspective.¹¹ These derivatives markets are regulated by a combination of private and public legal rules that operate *ex ante* and *ex post* (table 10-1 shows this graphically). His assessment:

First are private *ex ante* legal rules developed primarily by the International Swaps and Derivatives Association, Inc. . . . for OTC [over-the counter] derivatives (and by various exchanges and self-regulatory organizations for exchange-traded derivatives). The recent trend has been toward increased privatization of derivatives regulation, with trading volumes shifting from exchanges to OTC transactions, and this trend is likely to continue. . . . Second are private *ex post* legal rules applied by arbitrators in disputes, particularly those of the National Association of Securities Dealers. . . . Arbitration has

10. Pistor (2000, pp. 46, 47).

11. Partnoy (2002).

Table 10-1. *Derivatives Regulation Framework*

	Private	Public
Ex-ante	Contract	Congress
Ex-post	Arbitration	Courts

Source: Partnoy (2002).

numerous drawbacks, especially uncertainty, and likely will not predominate in future adjudication of derivatives disputes. . . . Third are public *ex ante* legal rules, including securities, commodities, and banking law and regulation, but also including derivatives-specific rules. Historically, public regulation in these areas has not achieved its goals; instead public legal rules too often have generated perverse incentives related to regulatory arbitrage, regulatory licenses, and regulatory competition. . . . Fourth are public *ex post* legal rules, including rulings by courts adjudicating derivatives disputes. Thus far, judges have shied from deciding important issues in derivatives disputes, and end-users of derivatives increasingly avoid litigation—even when losses are large—because of the high costs of discovery and motion practice.¹²

Partnoy's conclusion: "The recent trend to privatize legal rules applicable to derivatives is likely to continue."¹³

Private Legal Rules: Powerful and Pervasive

Private legal rules are powerful and pervasive. Contracts are at the heart of any market, and capital markets are no exception. From the central contract of purchase and sale radiates an extensive network of complex contractual relations that make the market function. The Euromarket (originally the Eurobond market) is a highly successful capital market governed

12. Partnoy (2002, pp. 2–3).

13. Partnoy (2002, p. 36).

virtually exclusively by various forms of private legal rules. It has proven remarkably resistant to the intrusion of public legal rules.

At their origin, stock exchange listing rules for example, are private legal rules, adhered to by contractual arrangement. This, in fact, is often the main source of their weakness as a regulatory mechanism in case of market abuse; because they rely on contracts, stock exchanges ordinarily may go no further than delisting (resiliation of the contract to list) or public censure.¹⁴ Over time, listing rules have been transformed in many cases by an overlay of public legal rules, so called “statutory backing” or subjugation to supervisory oversight, thus evolving into a form of quasi public legal rule. Contracts are also at the heart of the corporate entity. Modern U.S. legal theory looks at the corporation as a “nexus of contracts.”¹⁵ In the interest of efficiency, corporate law—the public legal rules—acts primarily to establish a standard form of contract, or a set of default rules, for the organization of corporations.¹⁶ In private or closed corporations, the incorporators themselves, and subsequent shareholders, may vary these rules (and often do) virtually in their entirety by contract. Private companies are the predominate corporate form throughout the world, in most cases comprising 99 percent of incorporations or registrations. They are creatures of contract and rely on contract, in the form of by-laws and shareholders agreements in particular, for their operation.

The primacy of contract in the market also underpins the dominant regulatory approach to the capital markets (and therefore to corporate governance): the Anglo-American disclosure-based regimes. Why is transparency so fundamental? Because a guiding principle of the capital markets is still

14. But see the later discussion of mandatory arbitration of shareholder disputes required of companies listing on Brazil's Level 2 or the Novo Mercado.

15. Pinto and Branson (1999, pp. 115–16): “Law and economic theorists conceptualize the corporation in terms of contract law. A corporation can be viewed as a nexus of contracts through which various claimants such as creditors, workers, shareholders, and consumers enter into agreements. Private contracts are an efficient means to lower transaction costs in the agency relationship between the shareholders and managers. One can view the articles of incorporation and the bylaws as a contract between the shareholders and the managers setting out the rules governing their relationship. This private ordering through contracts allows the parties to provide rules to maximize value and minimize costs. Under this view, corporate law should provide the basic terms of these contracts (that is, default rules), but the shareholders and the managers should be allowed to change the terms, thus providing an optimal and mutually agreeable system.”

16. In the United Kingdom and many Commonwealth jurisdictions, contract is still the basis of the formation of a company; the memorandum of association—the contract among the founding members—is registered to establish limited liability and legal personality.

caveat emptor, let the buyer beware, from the Roman law of the contract of sale. The nature of these public disclosure-based rules, is determined by their deference to the private legal rules of the market.

What are the characteristics of the contract: it is consensual, flexible, and, optimally, both self-enforcing and *independent of the political process*. Each characteristic can vary in degree, but the consensual nature of the contract is arguably its defining characteristic. Standard form contracts, rife in the securities industry, are largely inflexible, either for the sake of predictability and convenience or because of the superior bargaining power of one party, but they are still consensual. By-laws or industry association rules are a variation on standard contracts.¹⁷ In becoming a member of the organization or company, the member agrees to abide by the rules. The contract thus forms the basis of so-called self-regulatory organizations so prevalent in the Anglo-American securities industry.

Private contracts have drawbacks, of course. In the absence of agreement, there is impasse, and recourse must be had to public legal rules, which are rigid, prescriptive, circumscribed, and subject to the vagaries of political process. Nevertheless, in certain circumstances public legal rules are more effective than private legal rules.

A Framework for Rulemaking

To begin to sort out the various effects of and relations between private and public rules, we have developed a framework for rulemaking, shown in table 10-2, and then examine how several recent initiatives fit this framework. Table 10-2 takes as its starting point the two-by-two matrix of public versus private ex ante and ex post rulemaking developed by Partnoy to describe derivatives regulation. However, applying the same strict public-private dichotomy would, in our view, too dramatically oversimplify the typology of corporate governance initiatives drive by capital markets in recent years in emerging markets. Accordingly, we have added a column to provide a home for mixed private-public rulemaking. This facilitates sepa-

17. The derivation of the word "by-law" is interesting in this respect. According to the *Oxford English Dictionary*, it is believed to come from the Old Norse language "byrlaw": a local custom or law of a manor or district whereby disputes over boundaries, trespass were settled *without recourse to the public courts of law* or a regulation or ordinance agreed to *by consent* in baronial court.

Table 10-2. *Corporate Governance Framework*

	Private	Quasi-private/public	Public
Ex-ante	Contract	Sponsored “voluntary” standards	Law, regulation
Ex-post	Arbitration	Special arbitral bodies	Judicial

Source:

rate treatment of those contractual arrangements that are negotiated on a case-by-case basis between companies and stakeholders as well as “prepackaged” contractual arrangements that derive from voluntary adherence to a set of standards developed by third parties (such as the government, an exchange, a corporate governance code committee, or some sort of rating entity). Likewise, insertion of a box between arbitration and judicial enforcement helps to differentiate between general commercial arbitration systems and those that may be established especially to settle disputes over adherence to particular voluntary standards.

The cases that follow describe a variety of experiments in public and private rulemaking in a set of significantly different emerging markets. The set of cases we have included is neither comprehensive nor even representative of the full range of capital markets corporate governance initiatives that have been tried or may be tried. Rather, we believe that by analyzing a set of recent initiatives that includes elements that might fit into each of the boxes in table 10-2, some useful observations can be drawn. Accordingly, the cases cover instances of “pure” legal reforms, optional listing standards, “pure” issuer-investor contracting, government-sponsored “voluntary” codes, a mandatory disclosure regime, and the use of ratings.

Of course, the diagram remains simplistic in that it is static and does not capture the ebb and flow between private and public legal rules. Many of the initiatives we have examined incorporate one or more ex ante or ex post elements that may not fit neatly into a single box. This is probably evidence both of the ingenuity of the reformers and of the value of utilizing a mix of public and private legal rulemaking in the capital markets to address issues of corporate governance.

Case 1: Legal Reforms in Latin America

When corporate governance issues become popular fodder for the national press, as they have in both industrial and emerging markets, it is unusual for national legislatures to remain completely quiescent. Falling most squarely into the right-hand column of table 10-2 are the numerous reforms of company law and capital markets legislation undertaken in the emerging markets over the past five years. In Latin America alone, high-profile amendments to the legal and regulatory framework have become law in the four major markets: Argentina, Brazil, Chile, and Mexico.¹⁸ At least one smaller market, Colombia, is considering similar legislation.

Scandals, the Impetus for Reforms

The reforms of Latin American company and securities laws were typically conceived in the aftermath (or sometimes during the course) of scandals in the public securities markets involving perceived inequitable treatment of shareholders. In Chile the managers and controllers of the power company Enersis managed to secure fully one-third of the total price paid for control of the company in return for an economic interest in the company of far less than 1 percent. The shareholders of TV Azteca in Mexico took up arms after its controlling shareholder used the company as a virtual bank to finance his purchase of cellular licenses (after publicly insisting that he would never do such a thing). Investors in a series of Brazilian and Argentine companies were forced to accept “low-ball” offers from controlling shareholders who decided to delist the companies. Brazilian shareholders (most of them holders of nonvoting “preferred” shares of such companies) felt themselves unfairly frozen out of transactions in which control of the company was sold by those holding a majority of the voting shares.

As the case studies that follow demonstrate, capital market participants of one sort or another almost always undertook private initiatives in the area of corporate governance, either simultaneously or immediately fol-

18. Chile, December 2000 (mandatory tender offers, pension fund-nominated directors, class actions, special procedures and board committees for transactions with affiliates, and director responsibility); Argentina, June 2001 (mandatory tender offers, audit committees, shareholder rights); Mexico, June 2001 (nonvoting shares, independent directors, code compliance disclosure); Brazil, November 2001 (mandatory tender offers, accounting standards, board representation for minority voting and nonvoting shareholders, voting procedures, legal authorization for arbitration).

lowing the amendment of the legal framework. One problem with legislated reform is its generally applicability to all companies similarly situated (for example, all listed companies must comply with all legislation pertaining to corporate governance). Not surprisingly, the recent spate of Latin American legislative initiatives failed to enjoy the unanimous support of the business community. Typically, established firms with proven track records in the market or with dominant positions in the equity indexes were less enthusiastic about having to disclose additional information to shareholders or allowing outsiders onto their boards. Controllers fought doggedly against mandatory tender offer triggers that would have forced them to share control premiums with minority shareholders. During the reform debates, it became evident that many listed Latin American companies (including some blue chips) no longer thought of the public securities markets as a potential source of capital. Rather, a fair number of them anticipated selling control to larger national or, more often, international competitors (in transactions precisely like those in which the tender offer reforms were designed to apply) and thus were indifferent to the prices at which their securities traded in the markets. To the controllers of such companies, any strengthening of the tender offer regime was anathema.

Not all securities issuers or potential issuers were resistant. A handful of listed firms voluntarily amended their charters to incorporate some of the elements of the legislative reforms in advance of their passage. Several companies in Brazil negotiated tag-along rights for minority voting shares and even nonvoting shares before the legislated reforms were passed in 2001. A major Mexican company was the first firm there to adopt the Mexican code of best practices in a (so far unsuccessful) effort to turn around its reputation for trampling on minority shareholder rights. The less resistant firms typically expect heavy capital-raising requirements in the short to medium-term.

In the end, the final measures approved by the respective legislatures and executives in Latin America were more-or-less watered-down versions of what was initially proposed to the legislature. Chile's reformers were perhaps the most successful, but even there, majority shareholders were permitted to suspend the application of the law's mandatory tender offer provisions for three years. Mexico's legislation delegated authority for setting the parameters of the mandatory tender offer rule to the banking and securities regulator, which after much delay was able to issue strong mandatory bid rules in early 2002. Brazil's very comprehensive legislative initiative was the subject

of extensive horse-trading in the legislature. In the end, the mandatory tender offer requirement for nonvoting shares and the provisions that would have given minority shareholders control over fiscal boards, had to be dropped.

Early Results: Mixed

The promoters of the recent legislative initiatives in Latin America and in emerging markets elsewhere clearly hoped that by mandating greater transparency, providing shareholders with better tools to ensure equitable treatment, and beefing up judicial enforcement, the reforms would have a salutary effects on the development of capital markets. In the case of the Latin American reforms, it is certainly too early to make any definitive judgments about the long-term impact on access to and cost of capital, new offerings, liquidity, securities prices, or company performance. Two or three more years must pass before there is enough solid data to test the hypothesis that the reforms helped reduce the overall “governance discounts” in the respective markets, and resulted in more access to capital at lower cost. (One prominent analyst, however, already asserts that the Brazilian legal reform shifted the balance of power in Brazilian companies positively for minority shareholders and is recommending that investors buy minority voting shares in Brazilian firms.¹⁹)

Short-term anecdotal information presents a mixed picture. Clearly, the supporters of reform have succeeded in focusing the attention of companies, managers and directors, institutional investors, and the general public on the importance of corporate governance to the health of the capital markets (and by extension, the pension savings regimes). Although it is hard to judge just how much the legal reforms encouraged the development of private contractual arrangements discussed elsewhere in this paper, recent experience supports the conclusion that legal reforms can have the effect of accelerating the development and adoption of complementary or supplementary private contractual mechanisms (see the discussions of Brazil and Colombia, below).

The reforms have clearly been no panacea. In no case was there an immediate rise in equity prices that might have reflected a reduction in the

19. Deutsche Bank Latin America Strategy, November 5, 2001.

governance discount as a result of passage of the reforms. Controversial delistings and changes of control accelerated during 2001 and continue today. It may be that controllers have tried to “get while the getting is good” before the legal reforms were in place (and during the grace period before Chile’s mandatory tender offer regime goes into effect). Nor does the impetus created by the legal reforms for voluntary private contracting appear to be uniform. In Chile all public companies have duly constituted the conflicts committees required by the legislation, and growth companies, firms with American depository receipt programs (ADRs), and those with large pension fund stakeholdings have begun to improve their overall practices. However, Santiago’s tightly knit community of senior managers and directors has not experienced an epiphany. There has not been a general blossoming of interest in restructuring corporate boards to make them more effective watchdogs of shareholder interests. Privately led efforts (with support from the government) to develop a best practices code for Chilean companies have so far fizzled.

Case 2: Stock Exchange Listing Rules: Brazil’s Novo Mercado

The New York Stock Exchange requirements for independent directors and audit committees are often cited as an example of the positive role that self-regulatory organizations in the securities markets can play in improving corporate governance standards. However, before the mid-1990s, many stock markets in both developed and emerging markets resisted calls to impose higher standards on shareholder rights or board composition. Not surprisingly, this resistance was grounded in a concern that listing rules that exceeded minimum requirements of local company law might discourage new listings, particularly by start-up, founder-controlled companies. Most established listed companies were also less than anxious to change their practices. As with legislation, listing rules can suffer from the “one size fits all” problem. That is, all issuers are usually required to meet the same minimum standards, so the old guard resists.

Born of Need and Disappointment

The Novo Mercado initiative of the Sao Paulo Stock Exchange (BOVESPA), conceived in late 2000, traces its roots to the efforts to re-

form Brazilian company and securities legislation, discussed in Case 1. The initiative represents a quasi private effort to make up for the perceived shortcomings of legislative reform by creating a common mechanism to encourage voluntary adherence to appropriate standards, and providing specialized private dispute resolution. BOVESPA's leadership conceived the Novo Mercado at a time when two trends particularly worrisome for a stock exchange were evident. First, market capitalization and trading volumes in the public equities markets were contracting dramatically; and second, efforts to enact comprehensive corporate governance reform in Brazil were encountering strong political resistance, as described in Case 1, of the kind identified by Rajan and Zingales.²⁰

By the end of the 1990s, the weaknesses of the Brazilian capital market were painfully evident. In 1999 and 2000 there were no IPOs, few new issues by companies already listed, and a growing number of delistings. Liquidity was drying up for all but the largest companies as trading volumes declined. Another ongoing challenge for BOVESPA was a shift of trading in shares of the largest Brazilian companies to the ADR market in New York. While these disturbing trends were attributable to many factors, one of the more important was the perception by domestic and international investors that corporate governance practices of Brazilian companies were generally poor and legal protections inadequate (particularly those dealing with minority shareholder rights).²¹ BOVESPA decided that perception called for some sort of response.²²

The compromises that were made in the course of legislative consideration of the initial reform bill guided the content of the Novo Mercado listing rules. BOVESPA recognized that the well-understood and objectively determinable shortcomings of existing law that were not successfully addressed by the legal reforms could provide the basis for a voluntary rules-based response. BOVESPA's initiative can properly be called a "privatization" of part of the reform process.

20. Rajan and Zingales (2001).

21. McKinsey Emerging Market Opinion Survey (www.mckinsey.com/knowledge/articles/pdf/emergingmarketsurvey2001.pdf).

22. The President of Brazil's securities commission took a leading role in the effort to reform the company and securities law precisely because he shared the view that while improvements in corporate governance of Brazilian companies would not by themselves effect a recovery of the equity market, they were a necessary condition.

Different Strokes for Different Folks

The Novo Mercado is a listing segment of BOVESPA for companies that choose to commit themselves to the highest standards of corporate governance by contracting to follow a stricter set of rules.²³ In addition, BOVESPA created two intermediate listing segments, the Special Corporate Governance Level 1 and Level 2. The listing rules for levels 1 and 2 also require higher corporate governance standards than existing norms, but they are not as strict as the requirements of “full” Novo Mercado. Companies remain free to list under BOVESPA’s old rules, which simply require compliance with Brazil’s company and securities laws. Therefore, companies listed on BOVESPA can now choose among four listing segments, in ascending order of corporate governance standards: the old market, Level 1, Level 2, and the Novo Mercado.²⁴

By committing themselves to higher standards of corporate governance, companies that join the Novo Mercado hope that investors will respond by placing higher valuations on these companies’ securities—reducing the general “corporate governance discount” applied to Brazilian firms.²⁵ The creation of the Level 1 and 2 segments was a bit of an afterthought. Under pressure from their base of existing listed companies, BOVESPA had to offer something that would allow such companies to avoid appearing indifferent to investor concerns.²⁶

23. (www.novomercadobovespa.com.br/english/index.htm).

24. The idea of creating a separate set of listing rules within an established stock market was taken from the German Neuer Markt. However, an important difference is that the Neuer Markt was designed for companies from the technology, media and telecom sectors, whereas the Novo Mercado is intended for all companies wishing to demonstrate adherence to the highest standards of corporate governance, regardless of their industrial sector.

25. The most exigent of the Novo Mercado’s rules is that companies may not issue nonvoting shares. The other main rules require that public shares be offered through mechanisms that favor capital dispersion; that the company maintain a free float equivalent to 25 percent of the outstanding stock; that the same conditions provided to controlling shareholders in the transfer of the controlling bloc must be extended to all shareholders (tag-along rights); (v) obligation to make a tender offer at an objectively determined “economic value” share price should a decision be taken to delist from the Novo Mercado; (vi) that a single one-year term for the entire board of directors be established; that the annual balance sheet to be made available in accordance with accepted international accounting practices; and that quarterly reports be improved (consolidated financial statements were required).

26. Level 2 has almost all the same rules as the Novo Mercado, the notable exception is that Level 2 companies may still issue nonvoting shares. Level 1 relates mainly to transparency and disclosure, rather than shareholder rights. It is doubtful whether a company’s adherence to Level 1 shows a real improvement in its corporate governance; adoption of Level 1 standards are better viewed as a first step toward more substantial changes.

Novo Mercado and Level 2 companies, but not Level 1 companies, must settle disputes using the Market Arbitration Panel. (In anticipation of the Novo Mercado, the Brazilian legal reforms described in Case 1 explicitly strengthened the legal standing of voluntary arbitration, making the enforcement of arbitral awards easier.) Obviously, the establishment of the Market Arbitration Panel reflects market doubts about the effectiveness of the Brazilian judiciary to deal with shareholder disputes in a fair and expeditious manner.²⁷

Any Takers?

Since BOVESPA launched its corporate governance initiative, several public and quasi public entities have taken supportive action. BNDES, the Brazilian national development bank, has a simple formula for offering progressively lower interest rates on loans to companies that follow the requirements of Level 1, Level 2, and the Novo Mercado. The pension fund regulator allows pension funds to invest a larger proportion of their assets in companies listed on Level 1, Level 2, or the Novo Mercado, creating another incentive for companies to move to these listing segments.

The early results of BOVESPA's corporate governance initiative have been less than spectacular—a result that is explained almost entirely by the dismal economic scenario and market conditions prevailing in Brazil since 2001. The listing rules were officially launched in December 2000, but it was not until February 2002 that Companhia de Concessões Rodoviárias (CCR), a highway concession manager, became the first company to make an IPO on the Novo Mercado. As of April 2002 CCR remained the sole Novo Mercado company. Meanwhile, nineteen companies have joined Level 1, but none have joined Level 2 (although several have announced their intention to move to Level 2 in the near future). By focusing on transparency and disclosure issues, rather than on shareholder rights, Level 1 was envisaged as a stepping-stone to Level 2. However, the list of companies that have joined Level 1 includes several companies with doubtful corporate governance credentials; these companies are willing to disclose the information required to meet Level 1 standards but may have little intention or incentive to continue to Level 2.

27. The Market Arbitration Panel appears to represent a significant shift of power to shareholders and is reported to be perhaps the greatest single obstacle to persuading companies to adhere to Level 2.

Case 3: Ad Hoc Contracting in Brazil before and after the Reforms

Every time a company issues securities, it enters into a set of voluntary explicit and implicit contracts with investors concerning the company's governance. The company's charter, the terms of the securities, and any representations made in the marketing materials amount to explicit contracts, usually enforceable in law. Other understandings between issuers and investors—for example, that the company's voluntary governance practices will be in line with evolving market standards and expectations—may be more subtle (and less easily enforced). As investors in emerging markets have become more conscious of the shortcomings of governance during the debates over legal reforms, direct negotiation between investors and companies with respect to the governance practices of companies seems to have become more common, another example of Partnoy's observation on the trend towards “privatization” of legal rules. Two recent Brazilian IPOs (initial public offerings), one for ADRs issued before passage of the legal reform and the launch of the Novo Mercado, and another that was the first listing on the Novo Mercado, may illustrate this tendency.

Issuer-Investor Negotiations over Tag-Along Rights

Ultrapar is a large Brazilian liquefied petroleum gas and petrochemicals distribution company. Its 2001 total sales amounted to almost \$1 billion.²⁸ As of March 1, 2002, its market capitalization exceeded \$460 million.²⁹ Ultrapar decided to test the international market in 1999, offering non-voting shares to U.S. investors through a sponsored ADR program listed on the New York Stock Exchange. The company had a solid reputation in Brazil for professional management and comparatively good treatment of shareholders. Although descendants of the founder still held the largest block of Ultrapar equity, day-to-day control of the company had long been entrusted to a cadre of professional managers, many of whom had come to hold substantial amounts of shares themselves, mostly locked up in trusts set up as part of their long-term compensation packages.

28. Currency is in U.S. dollars unless otherwise specified.

29. Ultrapar's annual report is available at (www.ultra.com.br).

Despite Ultrapar's history of good shareholder relations, investors expressed concerns about the prospective treatment of holders of ADRs in the event of a change of control of the company. Neither the company nor its underwriters seems to have anticipated the investors' reaction. Given the existing control arrangement in the company (the descendants of the founder and senior management holding a majority of voting shares and a fair amount of the nonvoting shares as well) and the nature of the industry, it was reasonable to expect a merger or takeover in the future, at which point a fair amount of the value of the company would be realized. Under existing (and still current) Brazilian company and securities law, there was no requirement that a purchaser of a controlling interest offer to purchase the nonvoting shares, so ADR holders might be left out in the cold. The investors wanted "tag-along" rights, entitling them to sell their shares at the same price as the controllers and secure an equal share of the control premium.

After a certain amount of back-and-forth among the company, its underwriters, and investors, Ultrapar's chairman verbally committed to amend the company's charter *after the offering* to grant all nonvoting shares tag-along rights (something he could ensure, given the combined voting power of the founder's descendants and the management team). This undertaking was apparently credible enough to permit the offering to go forward. The ADRs were indeed successfully placed in October 1999. Investors and intermediaries felt that the company's reputation for fair dealing was sufficient "collateral" to assure that the chairman would make good on his promise. It may also have been understood that there was something of a community of interest between the investors and the management group, since the latter would have a direct interest in a higher share price once their shares of the company were released from the trust arrangements. Ultrapar did indeed amend its charter at its next general meeting of shareholders in March 2000.

Issuer-Investor Negotiation over Conflicts of Interest

The very recent case of CCR is similarly one of investors demanding protections that go beyond those required by law. Indeed, it is an example of investors and the company contracting for the whole gamut of protections and enforcement: the benefits of the Brazilian legal reform (Case 1), the Novo Mercado protections and arbitration (Case 2), and additional ad hoc

arrangements tailored to the company's special circumstances and investor concerns.

CCR is the result of the merger of a set of Brazilian highway concession managers. Its initial shareholders were Brazilian civil engineering companies (who build highways) together with a Portuguese construction contractor. The objective of its equity offering in the domestic market in early 2002 was to deleverage the company and establish a base upon which to finance expansion (that is, the purchase of new concessions). The company's controllers intended to sell a large minority interest (up to 49 percent) in the company. From the start, they committed that CCR would meet all the qualification for Novo Mercado—including one-share, one-vote; tag-along rights; international accounting standards; independent directors; and arbitration of shareholder disputes. In fact, CCR proved to be the first company to achieve a Novo Mercado listing. However, given the controllers' potential conflict of interest (together they represented most of the country's highway construction industry), investors insisted on protections going beyond those of the Novo Mercado requirements. Discussions focused on special procedures for approval of contracts between the company and the controllers. CCR's management is reported to have originally offered to empower a majority of the independent directors to order an appraisal (fairness opinion) in the case of any transaction in excess of \$1 million reais (US \$450,000) between the company and affiliates. In the end, the company had to go beyond this, agreeing that *any single director* could demand such an independent appraisal. This provision was duly incorporated into the company's charter and described in the final prospectus for the offering. The \$300 million real (US \$135 million) offering was successfully concluded in late January 2002.

Ad Hoc Contracting: Alive and Well

Ultrapar and CCR show that ad hoc contracting on corporate governance between issuers and investors is possible and practiced in Brazil. Ultrapar's experience was well known in Brazil and certainly contributed to the thinking behind, and the eventual content of, BOVESPA's Novo Mercado rules. Institutionalized contracting arrangements such as Novo Mercado can grow out of shared experiences with ad hoc contracting. At the same time, the CCR case demonstrates that institutional mechanisms such as Novo Mercado can also be supplemented by ad hoc arrangements that take the

“packaged” institutional arrangement as a basis upon which to build an appropriate company-specific governance structure credible in the markets.

Case 4: “Voluntary” Codes in Mexico, Russia

The understanding most practitioners have of a national code of best practices is that of a set of voluntary standards of corporate behavior produced by some sort of grouping of representatives from the private sector, government, academics, and market participants. However, in some emerging markets, it has been the government that has taken the lead role—either “push-starting” the effort or arranging for it to be carried out almost entirely by organs of the state (or persons handpicked by the authorities). The Mexican Code of Best Corporate Practices, adopted in 2000, and the Russian Code of Corporate Governance, adopted in 2002, provide illustrations of each approach.³⁰

Mexico: Push-Starting a Code

In the aftermath of the Mexican banking sector collapse of 1995–96, it was apparent that the financial system had done precious little to promote corporate governance among securities issuers and borrowers. The evident lack of transparency and accountability in the corporate sector greatly complicated the process of financial system resolution, contributing to the more than \$100 billion cost of the bailout of Mexico’s banking system. In late 1999 the Comisión Bancaria y de Valores (CNBV), Mexico’s banking and securities supervisor, launched an initiative to draft a code of best practices for public companies. Mexico’s Business Coordinating Council (the umbrella group including most national corporate and financial sector associations) was tapped to coordinate the private sector’s contribution to the effort, and it selected well-known academics and representatives of the legal community to participate. The result was a set of guidelines focusing largely on the quality of financial information and disclosure and on the composition and functioning of boards of directors. The code requires the boards of public companies to establish finance, compensation, and audit committees; a majority of directors on the audit committees must be inde-

30. For Mexico, see Business Coordinating Council, *Código de Mejores Prácticas Corporativas* (www.cce.org.mx). For Russia, see (www.fedcom.ru).

pendent of management and controllers. From the start of the process, it was expected that public companies would be required to disclose periodically the extent to which their practices are in compliance with the code. Soon after publication of the code, the CNBV issued a regulation requiring such periodic disclosure.

Russia: The Heavy Hand

Russia's new code of corporate governance had a more dirigiste provenance than Mexico's. The idea to draft some sort of code of practices was launched by the chairman of the Russian Federal Commission on Securities Markets (FCSM) in late 2000. A committee selected by the FCSM was assigned the task of preparing a final code within a year. Although informational public meetings were held during the first half of 2001, the discussions at these meetings had little actual impact on the drafting process. As initially conceived, the code was to be a (quite lengthy) compendium of existing law, regulation, and FCSM interpretation, as well as "recommended" practices not necessarily grounded in the existing legal and regulatory framework. An early draft of some of the code's chapters indicated that the document would not likely be very clear about which of its provisions were restatements of existing law, which represented FCSM interpretation of the existing framework, and which were to be regarded as merely hortatory.

Throughout the course of preparation of the code, the FCSM gave the market every indication that instead of establishing general guidelines of behavior as most national codes do, the Russian code would be quite prescriptive concerning the conduct of shareholders meetings, voting of shares, composition and activity of supervisory and management boards, financial accounting and audit, internal controls, and other aspects of corporate governance. The FCSM chairman made repeated public statements to the effect that the code would provide Russian companies with guidance on how the authorities would be enforcing the country's company and securities legislation. Although the chairman announced that the code drafting process was formally completed in December 2001, copies were not made available until two months later.

Prospects for Effectiveness and Enforcement

What is the significance of a "voluntary" code that is issued, for all intents and purposes, by the regulator? Should such a code be placed toward the

right column of table 10-2—legal prescriptions to be enforced in the courts (or through administrative action)—or toward the left column? Or should it be regarded as a mix, with *ex ante* characteristics of legislation, but with enforcement left mostly to private means? The ultimate answer in any particular case probably depends largely on the approach that the regulator takes to enforcement and that the courts take to interpretation. Regulators that push-start the code-drafting *process* but not its content or enforcement (as in Mexico) may accelerate the emergence of appropriate benchmarks for good governance—if the process is inclusive. However, if the regulator construes its code as akin to a law or regulation, particularly in an environment where judicial oversight of executive action is weak (as in Russia), then the code may come to be regarded as law. This may have important implications for compliance. In such a case, as with most laws, companies may come to regard minimum formal compliance as the goal, with perhaps negative consequences for development of more voluntary initiatives and even for the development of public discourse on the topic of corporate governance.

Case 5: Disclosure Regime in Colombia

Both industrial economies and emerging markets have experienced a virtual flood of national codes of best practices and independently conceived “codes” or “governance policies” adopted by individual companies. A not uncommon evolution has been to follow the approach taken in connection with the United Kingdom’s Combined Code: A national code of best practices is drawn up by a committee representing some mix of the business community, investors, intermediaries, and government. Public companies are then required by law, regulation, or custom to disclose the extent to which their practices differ from the code. Individual private companies may formally adopt the national code as their own or devise their own set of internal policies, which may go beyond the national code in some respects and not go as far in others.

Corporate Governance Activism in Colombia: A Combined Response

Very recent experience in Colombia provides an interesting example of the interrelation between public policy efforts and voluntary initiatives with respect to corporate governance. Before the end of 2000, both the public

and private sectors began to focus public attention on the shortcomings of the corporate governance regime and practices in Colombia corporations. In preparing a new capital markets law for presentation to Congress, the Superintendency of Securities insisted that the legislation had to address head-on perceived problems with enforceability of shareholders rights, transparency, board practices, and director and controller liability.³¹ At about the same time, the Confederation of Chambers of Commerce launched a corporate governance project to increase awareness by Colombian companies of market expectations, an effort joined by the Stock Exchange of Colombia, which was interested in preparing unlisted companies for the public markets, and the Pension Funds Association, representing the country's principal institutional investors.³² A benchmark national code project is in the early stages, with participation from all major private sector associations, but so far no drafts have been circulated or discussed publicly.

Superintendency of Securities Resolution 275

On May 23, 2001, Colombia's Superintendency of Securities issued Resolution 275 pursuant to its power to prescribe certain rules for issuers whose securities (both debt and equity) are to be eligible for purchase by Colombia's pension funds.³³ Perhaps because of concern that too prescriptive a rule might be resisted in practice or challenged in the courts on the grounds that it went beyond the Superintendency's statutory authority, Resolution 275 does not mandate specific shareholder protection, board practice, transparency, or enforcement provisions to be included in company charters.³⁴ Rather, Article 3 states that in order for a company's securities to be eligible for purchase by pension funds, the company must have "specific mechanisms" in place to ensure protection of shareholder rights and equitable treatment of investors.³⁵ Articles 4, 5, and 6 then require

31. Interestingly, in anticipation of further private sector initiatives, the draft law included specific legal authorization for corporate governance rating agencies.

32. Confederation of Chambers of Commerce, Corporate Governance Project (www.confecamaras.org.co).

33. Law 100 of 1993, Article 100, sections 3 and 4.

34. Article 7 of the resolution does require that companies achieve at least a 20 percent public float in their share within four years of the resolution's effectiveness.

35. Such specific mechanisms must at a minimum cover management control and oversight, conflicts of interest, identification and disclosure of risks, the election and role of the "revisor fiscal," special audits, internal controls, requirements for minorities to be able to call a shareholders meeting, and enforcement.

that these mechanisms be disclosed in some specificity to investors through the preparation, approval, and publication of a company-specific code of good governance.

In essence, Resolution 275 establishes a minimum disclosure regime for corporate governance for all Colombian listed companies (in practice, companies without access to the pension fund market are unlikely to achieve much liquidity in their shares or issue new securities). The companies themselves (and the market) are to interpret what the term “specific mechanisms” means, although companies will be hard pressed to avoid putting in place at least minimal measures in each of the areas specifically covered by the resolution. The resolution also injects the potential for three levels of enforcement. Judicial enforcement of company charter provisions will presumably now extend to those provisions amended by, or construed in accordance with, the provisions of the new codes (which must be approved by the board of directors and presented to the shareholder meeting). The Superintendency itself will play a role in ensuring that companies comply, at least in form, with the resolution—a role that may eventually lead to the use of the Superintendency’s disclosure oversight powers to influence the content of codes and companies’ compliance with them. Finally, Resolution 275’s references to enforcement seem to contemplate the adoption of arbitration mechanisms for enforcement of investor rights.

Two Poles: Company Responses to Resolution 275

Although most Colombian listed companies will not formally present their codes to shareholders until the 2002 annual general meetings season, many company boards have already approved codes and made them publicly available on the companies’ websites, through the media, and directly to pension funds. A number of companies appear to have opted for technical compliance. They apparently view Resolution 275 as little more than a “box-ticking” exercise and recite their existing charter provisions and practices with appropriate cross-reference to the resolution. Investors now have a clearer and more concise statement of such companies’ policies and practices, but the companies themselves have made no dramatic improvements in policies or practices.

Other companies seem to have embraced Resolution 275 as an opportunity to improve their governance practices and, just as important, to communicate their commitment to good governance to current and future investors. In a number of cases, company management (sometimes with

the help of outside governance consultants) drafted codes organized more along the lines of the Principles of Corporate Governance set out by the Organization for Economic Cooperation and Development (OECD), and with specific shareholder protections and transparency requirements that go beyond the general requirements of both Resolution 275 and the OECD principles. Although the codes that have been made available to the public so far exhibit a diversity of style and content, some of them clearly represent a new contract between the company and its investors in key areas of corporate governance.³⁶

TAKING THE BALL AND RUNNING WITH IT: INVERSURA. The code adopted by Inversura, an insurance holding company, is perhaps the most dramatic example of the use of a Resolution 275 code by a Colombian company as a voluntary contractual and privately enforceable mechanism of corporate governance.³⁷ The Inversura code is organized largely along the lines of the OECD Principles of Corporate Governance (with separate chapters for shareholders rights and equitable treatment, the role and organization of the board, and stakeholders), with an additional chapter covering ethical treatment of clients, suppliers, and government officials.

In its code, Inversura's management binds the company to a number of important shareholder protections and board practices that go well beyond the minimum requirements of Colombian law and Resolution 275. Cumulative voting is authorized, and the company is prohibited from issuing multiple voting or nonvoting equity. At least four of the ten board directors must be independent of management and controllers. The board is required to have audit, compensation, and governance committees, with the audit committee dominated by independent directors. Perhaps most significantly, the code provides that disputes between shareholders and the company will be submitted to arbitration by an outside panel, in this case the Commercial Arbitration Panel of the Chamber of Commerce of Medellin.³⁸

36. Given the circumstances surrounding their birth, it is probably fair to place all the Colombian codes issued in the aftermath of Resolution 275 in the center column of table 10-2, with those of the compliance-type more toward the right (Public) column, and those with shareholder-friendly and board professional codes closer to (if not actually in) the left (Private) column.

37. Inversura is not a public company, but devised its code in anticipation of its eventual entry into the public securities markets. Its code is probably the most shareholder-friendly and board professional that we have seen from a Colombian company, although others have taken similar approaches.

38. This last provision probably puts the Inversura code, and those of any companies in Colombia that approve similar provisions, solidly within the left column of table 10-2.

PROSPECTS. Colombian institutional investors report that Resolution 275 has had positive effects on transparency. All companies who want their shares to be actively traded must make public explicit charter provisions and company policies regarding shareholder protection, board practices, and disclosure. The resolution has helped move corporate governance up the public agenda and garnered a great deal of public attention. Indeed, Resolution 275 accelerated the very active collaboration of the Pension Funds Association, the Confederation of Chambers of Commerce, the Stock Exchange of Colombia, and the Superintendency of Securities in jointly promoting best practices in corporate governance throughout the country. This degree of formal voluntary cooperation among representatives of issuers, investors, intermediaries, and government is perhaps unique in an emerging market. It is probably fair to state that one reason cooperation has been possible is precisely the lack of prescription and the opening for voluntary initiative that Resolution 275 presented to the private sector.

It remains to be seen how well companies will actually comply with their new codes and how enforceable their obligation to do so will be in the longer term. The efforts that companies have expended to comply with Resolution 275 (preparation, board approval, and submission to the annual shareholder meetings) may have the unintended consequence of discouraging later amendment of the initial “compliance-type” codes produced by less progressive companies. It will be particularly interesting to follow the development of the initial codes over the next few years. Will there be competition among issuers to adopt more shareholder-friendly provisions? Or will a certain set of minimum standards be seen as sufficient? How active a role will the pension funds themselves play in pushing issuers to do more? Will the market permanently bifurcate into one set of issuers that take a progressive stance and another interested only in bare compliance? What will be the experience with enforcement? Will recourse to the courts remain the ultimate tool for enforcement, or will actions by the Superintendency of Securities and arbitration take on greater importance? And what will the contribution be to capital market development? It will require at least a few years before any firm conclusions can be drawn.

Case 6: Ratings

Corporate governance ratings can be characterized as an implicit private contract between a company and investors, partly enforceable through pri-

vate means (the left-hand column of table 10-2). The company promises to maintain certain standards of shareholder treatment, board practices, and transparency, and the institution producing the rating determines whether the company is upholding its part of the bargain. (The rating may involve a combination of scoring the company on its charter and practices and evaluating its relative position within the market.) If the company fails to maintain its rating, the company is penalized by reputational damage and, in theory, a consequent decline in the market value of its securities.³⁹

Certain corporate governance factors (notably the quality of transparency, internal controls, and auditing) are (or should be) important components of credit rating. But unlike the case of credit rating, a set of viable business models has yet to emerge for conducting ratings of corporate governance on a stand-alone basis. Instead, both developed and emerging markets are still in a “let a thousand flowers bloom” period. This is not the place to canvas corporate governance rating efforts worldwide. Rather, we merely note some of the more recent efforts with which we have become familiar in our work in emerging markets and provide some preliminary observations (and, perhaps, speculations).

Deriving Ratings from Voluntary Code Efforts

In some markets, sponsors of corporate governance codes have looked to ratings as a way of promoting adherence by companies to the provisions of such codes. Code sponsors tend to conduct rating exercises at their own expense and based on fully public information. The Stock Exchange of Thailand (SET) is collaborating on a ratings methodology linked to the Thai Code of Best Practices issued in 1999.⁴⁰ SET’s strategy at this point is to produce a first round of confidential ratings and relative rankings of listed companies to be divulged on an individual basis.⁴¹ Certain other markets in East Asia are currently debating whether to follow Thailand’s example.

39. As in the case of credit ratings, failure to maintain a corporate governance rating could conceivably trigger default under loan agreements, or make the company ineligible (or less eligible) for investment from some sources (such as pension funds).

40. Stock Exchange of Thailand, “The SET Code of Best Practice for Directors of Listed Companies,” 1998 (www.set.or.th).

41. Initially, each company will be told only its own score and its ranking relative to the other listed companies. A second round of ratings will be made public after companies have had a chance to react to the initial ratings by conforming their behavior more closely to the code.

The drafters of the first corporate governance code in Poland, the Gdansk Institute for a Market Economy (GIME), a respected Solidarity-affiliated think tank, produced a set of ratings for a subset of companies on the Warsaw Stock Exchange earlier this year. CIME intends to publish a fuller set of ratings later in 2002. Ironically, GIME's code is not supported by the Warsaw Stock Exchange, which has initiated its own code-drafting effort, with the collaboration of market participants and issuers. WSE, or the rules of the Polish securities regulator, is expected to require that each listed company disclose on an annual basis the extent of its compliance with the exchange-sponsored code rather than with GIME's.

National shareholder rights groups have also undertaken rating initiatives. One of the best-known of these groups, Russia's Institute for Corporate Law and Corporate Governance (ICLG), initiated a ratings service in early 2001, after an extended period of consultation with local and international experts to arrive at an appropriate methodology. ICLG is a non-profit institution that makes its basic company ratings public. However, it also maintains a fee-based subscription service for investors, which provides much more detailed information on the corporate governance of individual Russian listed companies. ICLG clients may also contract for in-depth corporate governance reviews of particular companies in which they are considering an investment. Although some ratings are conducted with the cooperation of the subject company (and some are clearly not!), ICLG receives fees solely from investors.

In Search of a Viable Business Plan

For-profit commercial services that rate corporate governance in emerging markets appear still to be searching for a business model that will prove viable in the long term. Some of these efforts are operated in close association with general equity research and analysis; examples include CLSA in Europe and Deutsche Bank Alex Brown, which recently launched a global effort based in New York. Standard & Poor's Corporate Governance Rating Service, although so far active in only a few markets, intends to operate as a stand-alone business. As in the case for its credit ratings business, S&P expects its customers to be mostly the rated issuers themselves; the results will usually be published, as in the case for its equity research services. S&P hopes that companies with good governance will use an S&P rating as a vehicle to attract investors. S&P also hopes that its reputation for careful

analysis and integrity will make such ratings credible in the markets, despite the fact that the rating is paid for by the issuer.⁴²

In contrast, a new company, Governance Metrics International, seeks to provide investors with corporate governance ratings for companies across entire markets both in developed and developing countries. Although the service has not yet been launched, its sponsors have developed a methodology that incorporates evaluation of company-specific and country-specific data to produce scores that they contend can be compared between companies in the same market and across markets. The service is intended for institutional investors with large portfolios in a variety of markets. The scorings will not be made public. Nonetheless, were such a model to prove economically viable, it is likely that enough elements of the methodology would become well enough known in the markets that some companies would take steps to improve their governance in ways that would likely result in higher scores.

What Flowers Will Produce Fruit?

Each of the approaches to corporate governance ratings described above has its virtues and limitations. How effective any one system of ratings can be as a system of private quasi contracting depends on a variety of factors, including quality of methodology, perceived impartiality, comparability of ratings between companies and across markets, and breadth and depth of coverage. Clearly at this stage some players in the market think there is a future for corporate governance ratings. A better indicator of the future of corporate governance ratings would be their inclusion in loan covenants, in legal investment rules (for example, pension funds), and in the formulation of market indexes.

Implications for Capital Markets and Corporate Governance

Although it is too soon to make definitive judgments about what works, several general observations can be made about the role of private and

42. The S&P business model may result in incomplete coverage of each market since only a handful of companies are likely to take on the expense of securing a rating in any given emerging market.

public legal rules in promoting the development of capital markets and enhancing the governance processes of corporations.

—Private legal rules are important.

—Different legal traditions have different balances in terms of the effectiveness of private or public legal rules.

—A predictor of effectiveness of any particular governance mechanism may be its form (private, public, or quasi public legal rule) and the legal tradition in which it operates.

—Public policymakers should anticipate and encourage private and quasi public legal rules that complement and reinforce public legal rules of corporate governance.

—The optimal content and mix of mechanisms in any market depends on a variety of factors. Some of the most effective mechanisms may be found in these intermediate forms, quasi public legal rules, enforceable by private means.

Private Legal Rules Are Important

The regulation and governance of capital markets and has been very much an Anglo-American debate over the last several years; not surprisingly, the governance mechanisms that have proliferated recently find their origins in Anglo-American law and practice. Although the debate surged into public prominence ten to fifteen years ago, corporate governance has been the daily bread of lawyers and accountants for a hundred and fifty years. Over that time, fairly standardized private legal rules developed and were inserted into negotiated partnership contracts, shareholder agreements, and private company by-laws to balance and protect the ongoing economic interests of participants and, if necessary, provide for exit from the enterprise and for dispute resolution without recourse to the courts. In commercial matters the courts were a last, and undesirable, resort.

Particularly in the United States, these contractual governance mechanisms were transformed into legislation, or public legal rules, applicable often on a default basis to private or closed corporations.⁴³ Such mechanisms included cumulative voting to ensure board representation for minority shareholders, tag-along rights in cases of changes of control, puts

43. That is, nonmandatory; consistent with their consensual, contractual origins, they would operate unless otherwise specified by contract or corporate constitution; see the Revised Model Business Corporations Act (1984).

and calls in various circumstances to provide an exit, valuation mechanisms to determine economic interests, disinterested voting techniques to deal with conflicts of interest, buy-out or appraisal mechanisms triggered by certain events; arbitration and nonjudicial dispute resolution. Some of these contractual governance mechanisms were adapted and crossed over to the realm of public corporations; their outlines, for example, can be seen in the 1964 Williams Act in the United States, the source of U.S. tender offer rules.

These contractual governance mechanisms, or private legal rules, figure prominently, in different forms, in the Latin American case studies. Private legal rules, or contracts, are important in and of themselves, but they are also important in two other respects. Private legal rules generate market-tested solutions that can, over time, provide the basis for public legal rules of greater general applicability. And, as Partnoy observed, public legal rules may migrate back to the private sector in search of a more effective form of implementation.

Different Legal Traditions Have Different Balances

Even within the common law tradition, there are significant differences between the two main branches of the tradition, the English (now Commonwealth) tradition and the American. The American common law tradition branched off more than two hundred years ago at the time of the American Revolution and in some interesting respects has greater affinities with the continental European civil law tradition than with the English common law.

The American and English traditions share a heavy reliance on ex post public legal rules: the courts. As every common law student learns, for reasons reaching back to the English medieval court, there is no right without a remedy. This heritage persists and endows procedural elements of the law and the judicial system in common law countries with great importance.

In the English common law, the importance of judicial action continues to dominate even statutory law, the ex ante public legal rules. The English common law system demonstrates to this day a surprising aversion to ex ante public legal rules. Large and complex swathes of English law have never been legislated, but instead have developed through case law. Trust law, from which the concept of “fiduciary duties” derives, is a prime example; the fundamental principles remain judge-made. The American legal tradition shows no such aversion to the use of legislation; in this, its proclivities are

more in line with continental European legal traditions. It is no accident that the United States has a uniform commercial code (or a bankruptcy code, or any number of other state and federal codes).

As for the continental European legal tradition (which serves as the basis for the legal systems of much of the non-Commonwealth world), its defining characteristic is the importance of written law, particularly as embodied in the great nineteenth century civil and commercial codes. If in the common law world there is no right without a remedy, then in the continental European tradition, there is no right without a written law. A second, related characteristic of continental European law, virtually unknown in the United Kingdom, is the hierarchy of law: with the constitution at the top, followed by codes, then statutes, and then regulation. Like a game of cards, a civil or commercial code provision will always trump a provision in specialized legislation.

Form and Legal Tradition May Predict Effectiveness of Governance.

The same governance mechanism may take different forms and the form in which it will be most effective may be determined by the legal system in which it operates. La Porta and others are correct; legal families do matter. Pistor is correct; the manner in which a legal concept is introduced or transplanted matters. And the form that a rule takes matters. Some of the otherwise “inexplicable” failures of the waves of capital markets and corporate governance initiatives can be traced, in part, to a failure to recognize the importance of these observations.

Here are three concrete examples of some of the most popular governance mechanisms (voluntary codes, cumulative voting, and class actions) that may not survive transplantation to another legal system because they are an inappropriate form of rule.

VOLUNTARY CODES OF CORPORATE GOVERNANCE. Voluntary codes have been probably the most popular corporate governance mechanism of the 1990s, proliferating around the world irrespective of legal tradition, corporate ownership patterns, or level of development of the capital market. They trace their immediate origins to the Cadbury Report issued in the United Kingdom in 1992. Subsequently revised, it is currently known as the “Combined Code.”⁴⁴

44. Committee on Corporate Governance, “The Combined Code” London, 1998. <<Please say how a reader can obtain a copy of this code.>>

The most significant feature of the Combined Code is that it is not written law, but rather a “voluntary” code. Now, in the continental European tradition, a voluntary code is an oxymoron. A code, according to the *Oxford English Dictionary*, is a written body of laws so arranged as to avoid inconsistency and overlap.

So if it is not legislation, what kind of creature is the Combined Code? The *Oxford English Dictionary* gives a variant meaning of the word *code* as “a set of rules on any subject, *esp.*, the prevalent morality of a society or class; an individual’s standard of moral behavior.” A code in the United Kingdom, in other words, is one of the weakest forms of private legal rule, if that—no more than a set of guidelines without even the binding force of contract that a set of industry association rules might possess by virtue of contractual membership obligations.

The questions then become: why this choice of form, and how effective can the Combined Code possibly be. To deal with the second question first, reasonably effective in the United Kingdom, all other things being equal. Remember, this is a country that relies on unwritten parliamentary conventions in lieu of a written constitution and that has a respectable, if now fraying, tradition of the use of moral suasion as a regulatory technique. The Combined Code is not the only voluntary code; the U.K. City Code on Takeovers and Mergers is not written legislation, as many people think, but a voluntary code.

As to why this choice of form, the answer is more elusive. It is not as though the United Kingdom were emulating an existing voluntary code. Several of the substantive recommendations of the Cadbury Report (the use of audit, remuneration, and nomination committees, for example) are taken directly from the listing rules of the New York Stock Exchange. These listing rules we would characterize as quasi public rules: their binding nature derives from contract, but their substance is subject to regulatory oversight of a public agency, the Securities and Exchange Commission. The use of audit committees by companies listed on the New York Stock Exchange is not a pious wish; it is a mandatory requirement.⁴⁵

45. The origins of the audit committee requirement can be traced to 1975 and the new Canada Business Corporations Act, which made audit committees mandatory for federal public companies. The interesting twist here is that, although inspired in many respects by the U.S. Model Business Corporations Act, the Canadian legislation was also subject to the beneficent influences of the Quebec Civil Code (itself at that time based largely on the French Napoleonic Code), in terms of legislative approach and drafting techniques, and with its continental European bias in favor of written law, *ex ante* public legal rules. So, one rule, three different but related manifestations.

The question remains: why did the Cadbury Report take the form of a voluntary code? The usual virtues of private legal rules can be cited: flexibility, responsiveness, sensitivity to industry specific concerns and considerations. The peculiar British aversion to written legislation also shines through. Yet even subtler forces may be at work in influencing the form of these rules.

The Cadbury Report focused on the composition and responsibilities of boards of directors. The directors of English companies, like their American counterparts, are subject to fiduciary duties derived from very ancient legal concepts of trust law. Early nineteenth century English businesses, predating the various companies laws enacted over a period of several decades, were organized as trust vehicles with what would now be the role of the directors being assumed by trustees. Trustees were subject to strict fiduciary duties of fair dealing, impartiality, and accountability, which because of a quirk of medieval history, were enforced by a separate ecclesiastic court system, the Courts of Equity. Because fiduciary obligations are triggered whenever ownership of property is separated from its management, these carried over to boards of directors as the separation of ownership and management of corporations evolved into the shareholder director structure. Enforced by the Courts of Equity (literally, “the court of fairness”), fiduciary duties are suffused with moral righteousness. What more appropriate a vehicle could there be than one establishing “a standard of moral behavior,” a voluntary code.

While a voluntary corporate governance code might work well in the United Kingdom, how effective is it likely to be elsewhere? Would voluntary codes transplant to continental European law systems or to the complex hybrid legal systems of Asia (legal families matter). The sorry saga of the new Russian code of corporate governance, described above, is indicative of the confusion and muddle (is it law/is it not) that can result from dropping a voluntary “code” into an essentially continental European system that does not recognize the concept. Here is where the capital markets may, ironically, be having a perverse effect on the governance of corporations. International capital markets have been so dominated in recent years by Anglo-American law and practices, that the spillover into local laws and practices, regardless of legal tradition, has been inevitable, if uneven. Some of this spillover may be ineffective because the mechanisms introduced are incompatible with the underlying legal system (fiduciary duties, for example) or conflict with civil or commercial code provisions (in which case, the

newer elements are simply trumped, by the older code or even constitutional provisions that are higher in the legal hierarchy).

Other mechanisms, and voluntary codes may be among them, may in fact be detrimental to improving corporate governance. By deliberately introducing an ineffective, but internationally recognized, corporate governance delivery mechanism, political interests may divert attention from approaches that would in fact be more effective, but equally, more disruptive to the cozy corporate and political status quo.⁴⁶

Give all this, how effective is the voluntary corporate governance code in Germany, referred to at the beginning of this article, likely to be? Perhaps the editorial writer at the *Financial Times* was justified in expressing skepticism about prospects for change. At the same time, as ineffective as such a mechanism may be domestically in raising levels of corporate governance, it may have an important signaling effect in the international markets. To the extent that corporations participate in the international capital markets (and that may be only a tiny fraction of a country's corporations), other more effective corporate governance mechanisms would be engaged (foreign listing rules, compliance with U.S. securities laws and regulations, for example). Where there is little interest in international capital markets, there may be little interest in triggering the signaling effect of introduction of a domestically inappropriate, but internationally recognized, corporate governance mechanism.⁴⁷

CUMULATIVE VOTING AND CLASS ACTIONS. Second only in popularity to voluntary codes of corporate governance has been the introduction of cumulative voting mechanisms and class actions in emerging and transition economies. Both procedural mechanisms originated in the United States and are designed to enhance minority shareholder representation at the board level and to promote management accountability. Public investors in the capital markets can use these mechanisms to influence corporate governance directly.

46. Rajan and Zingales (2001).

47. Tunisia, for example, with a very "pure" French civil law tradition, has recently introduced a new corporate law designed to improve various aspects of governance, but it has little interest in a voluntary code of good corporate governance or judicially oriented shareholder remedies (ex post public legal rules). As one Tunisian legal expert explained, the concepts are inconsistent with the legal tradition, which prefers structural adjustments to the corporate law (ex ante public legal rules). To the extent that Tunisian corporations have little interest in participating in international capital markets (nondomestic activity is more likely to be focused on France and Italy), there is little need to send a signal to the international capital markets.

Again, the primary virtue of such governance mechanisms is their signaling effect to international capital markets. U.S institutional investors recognize the signal: the domestic market has become aware of and taken up the corporate governance debate. As an effective means of promoting better governance in the corporate sector domestically, however, cumulative voting and class actions are likely to prove disappointing. They are the wrong form of legal rule for most of the legal systems in which they have been transplanted, and they may have been implemented by the wrong method, that is, imposed rather than adopted voluntarily.⁴⁸

The introduction of cumulative voting and class actions in Korea provides an example. The Korean legal system has been strongly influenced by German models, via Japan; it preferring *ex ante* public legal rules, written law, and structural mechanisms within its corporate law that create, in theory, a balance of power among the constituents. Procedural rules and reliance on *ex post* public legal rules are limited in their effectiveness in Korea, as they are in the Japanese and German legal systems.

Cumulative voting originates in private legal rules (corporate charters or by-laws) as a procedural mechanism, and a cumbersome one at that, to allow minority shareholders to pool their votes and thus ensure some degree of representation on the board of directors in the absence of a statutory right to direct representation. It was a compensatory mechanism to override the principle of majority rule, whereby a majority shareholder could elect an entire slate to the board. In the United States, cumulative voting passed from private legal rule to statutory formulation, becoming a mandatory feature in many state laws. Over time, however, with a shift to more manage- friendly corporate laws in the United States, cumulative voting started to slip back into the realm of private legal rules; it remained a feature of corporate statutes, but was made optional in most states. German corporate law, in contrast, has long provided a statutory mechanism to ensure that certain constituencies have direct representation on supervisory boards.

In the aftermath of the 1997 Asian financial crisis, Korea acted quickly to try to reestablish confidence in its markets; among other actions, waves of corporate law reforms were enacted, some at the suggestion of the international financial institution community. Cumulative voting provisions

48. Adoption of cumulative voting and class actions has often been highly recommended or otherwise "imposed" by international financial institutions. See Pistor (2000).

were among the reforms, but they were of the weak, or quasi public, variety. They were not mandatory and could be bypassed in the corporate charter. Although Korean academics had raised questions about the effectiveness of these optional or default rules, international advisers assured them that this was the modern formulation in the United States. The result: Korean corporations moved quickly, and predictably, to neutralize cumulative voting rules by charter amendments, rendering the statutory but nonmandatory rules ineffective. Wrong rule; wrong form.

Class actions are even less likely to be effective in most transitional or emerging markets. At least with cumulative voting, there is a chance of developing rules that could work in the context of corporate legislation to which they were not native. Class actions, however, fall squarely into the category of ex post public legal rules, dependent upon the existence of an experienced judiciary, an extensive network of other procedural rules, an active body of litigation professionals, and a general populace with a litigious bent. They are procedural rules in the great common law tradition of “no right without a remedy.” Class action provisions dropped into the corporate law of transitional or emerging market economies are virtually always dead on arrival. There are no procedural rules or institutions to support them.

*Private and Quasi Public Rules Should Complement
Legal Rules of Corporate Governance.*

The relationship of private legal rules and public legal rules is not necessarily static (as in the Partnoy matrix) but rather a more fluid continuum with intermediate forms. In nearly every case we have studied, efforts to improve corporate governance in an emerging market involved simultaneous or sequential initiatives in the public and private sectors. Brazil’s response to the challenge seems to be the most vibrant in this regard, with a great deal of activity at the public legislative level and among quasi public entities like BOVESPA, accompanied by positive examples of ad hoc contracting at the corporate level. In addition, the fully private Brazilian Institute of Corporate Governance has played an important part in the dialogue, developing a voluntary code of best practices and an active training program for companies and corporate directors.⁴⁹ As described earlier,

⁴⁹ The Brazilian Institute of Corporate Governance’s code of best practices and calendar of trainings can be found at (www.ibgc.org.br).

public legal reforms anticipated private efforts like BOVESPA's Novo Mercado and reinforced the legal status of private arbitration.

Colombia probably represents the clearest example of public and private policymakers recognizing the value of complementary public and private legal efforts. Almost from the start, the quadrilateral of the securities regulator, the confederation of chambers of commerce, the stock exchange, and the pension funds association engaged in active consultation and cross-support. There is little doubt that this collaboration accelerated corporate governance's visibility as a key issue in the development of capital markets in that country. The Superintendency of Securities' draft capital markets law anticipates the development of corporate governance rating services and shareholders associations. The result in Colombia may in the end involve the same set of public and private mechanisms that have emerged in Brazil—legal reform, changes to listing rules, a national code of best practices, and more active ad hoc contracting. However the relative scope and importance of each element is likely to be different.

In the other countries covered by the cases, the interrelation of public and private law efforts has been less prominent (and successful), but still evident. Active institutes of corporate governance with leadership from both issuers and investors have emerged in Argentina and Thailand. Two Russian groups established director institutes in 2001, one perhaps more closely associated with government, the other more distant. An aggressive private sector response to the corporate governance challenge has been less evident in Chile and Mexico, both countries that have historically had exceptional access to international capital markets. It is possible that this has encouraged complacency among blue chip companies with active ADR programs. The peculiarities of the pension fund regimes in each country may also have contributed to complacency. The rules governing Chile's long-established and large pension industry create incentives for funds to mimic each other's portfolios, Mexico's industry is still nascent and invested almost exclusively in government securities.

Although the legal reforms already undertaken do not seem to have yet produced the effects their supporters hoped they would, there appears to have been a qualitatively better early response from companies in countries like Brazil and Colombia where quasi public and private legal mechanisms were anticipated by policymakers. Accordingly, one of the tentative lessons of recent experience with capital market corporate governance efforts is that policymakers should anticipate complementary private sector initia-

tives and do what they can to make the public legal framework accommodate them. However, policymakers cannot be expected to be able to predict with any certainty the kinds of quasi public and private initiatives that will emerge or be successful. The cases we have studied yield no template of how best to fill in the spaces in table 10-2. Policymakers would thus be wise to retain the flexibility to reinforce effective quasi public and private law initiatives as they emerge.

It would also be surprising if even within a single market the effective combination of mechanisms remains static. While emerging markets are currently in a period of experimentation in this area, the landscape of mechanisms will undoubtedly change as some prove more effective and adaptable to new circumstances than others. Policymakers need to follow developments carefully and retain the flexibility to respond when necessary to encourage and accommodate effective private rulemaking.

Optimal Content and Mix of Mechanisms in Any Market Depends on Many Factors.

The emerging markets we have studied differ importantly along many dimensions in addition to the existing legal framework and historical legal tradition. Key market characteristics that almost certainly affect the trajectory of public and private corporate governance initiatives and their prospects for effectiveness include:

—Relative adequacy of existing practices. Are the salient problems relatively objectively determinable (such as a lack of tag-along rights, too many nonvoting shares, application of substandard accounting rules, uncertain rules for protection of minority shareholders in delistings) or more subtle (poor audit quality; lackluster boards; managers, boards, regulators, and investors in conflict)?

—Number, size, and industry of public issuers. Is there a clubby atmosphere among controlling shareholders and corporate executives, or are there multiple centers of entrepreneurialism, competing aggressively in the financial markets (and perhaps in the political sphere as well)?

—Number, size, and nature of principal investor groups (institutional, pensions, international). How well are the investors themselves governed? Are there distortions in their incentives or conflicts of interest that limit the extent to which they are profit-maximizers?

—Resources of the enforcement mechanisms (courts, regulators, existing alternative dispute resolution). What enforcement agents are realistically in

the best position to see that contracts are performed, standards observed, and regulations complied with?

Markets are idiosyncratic. Indeed, the importance (and even the presence) of the economic actors involved in public debate over reforms and private initiatives is a function of the characteristics of the market. In the interest of encouraging further examination, analysis, and debate among scholars and practitioners, we offer some tentative observations:

—Standardized private rulemaking (and dispute resolution), such as the *Novo Mercado*, probably works best when there is general agreement on the set of objectively determinable deficiencies that exists with the legal framework and governance practices, and when there are a reasonably large number of issuers and investors (such that no single issuer or investor is likely to set the standards itself and negotiate directly).

—Private standard setting of any type (be it listing rules, voluntary codes, or rating criteria) are likely to have the most immediate impact on the IPO market, as such standards provide investors with a common negotiating position. A prominent Latin American policymaker once told a group of foreign institutional investors after a meeting with local CEOs whose companies had already achieved access to the public securities markets, “one day this market will have companies with good governance, but it won’t be the companies run by the guys you just met.”

—Ratings may be a more valuable tool for encouraging better practices where the number of issuers is relatively small, so that a larger portion of the market can actually be rated and thus provide good comparatives. However, a large enough set of investors (local pension funds or international investors) is likely required to make the exercise viable from a business perspective. This paradox leads us to suspect that devising a viable business model for ratings will be problematical for some time.

In this early stage it is hard to make any definitive conclusions about what specific guidance the recent experiments in public and private law in emerging markets can provide those interested in improving the corporate governance practices of companies in such markets. However, their early popularity and some encouraging results from the initiatives in Brazil, Colombia, Thailand, and elsewhere, lead us to suspect that there is likely to be space in many emerging markets for intermediate forms of quasi public legal rules, enforceable by private means (such as special listing segments, ratings, and other types of benchmarking, and investment disclosure regimes). Indeed, some of the most effective mechanisms may be found in these intermediate forms.

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