Corporate Governance and Emerging Markets: Lessons from the Field

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ABSTRACT

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Although it may be too early to pronounce on the relative effectiveness of various capital market–driven corporate governance initiatives, experiences in emerging markets over the last decade, especially Latin America, lead to some preliminary conclusions.
These observations may have some predictive value in gauging the potential effectiveness of any particular initiative. "Voluntary" codes and procedural remedies drawn from Anglo-American law, for example, may not be the most effective means of channeling market forces to the improvement of corporate governance in continental European–style legal systems. These transplants may behave a little differently than expected; at worst, they may have somewhat perverse consequences, where an internationally recognized, but domestically ineffective, rule is introduced into a system. The Latin American cases studied are instructive in this regard, as governance mechanisms were introduced in multiple guises along a continuum of private and public rules, amplifying the prospects of effectiveness.

Emerging Markets and Corporate Governance: Lessons from the Field*

It has become a truism that the pressures of the capital markets will improve the governance of corporations and that improvements in corporate governance will promote the development of capital markets. However, the relationship of capital markets to the governance of corporations is neither simple nor linear; rather, it is more in the nature of a complex feedback loop, a dynamic process responsive to many factors. Law is one of those factors; law is the delivery mechanism. How effective capital markets are in exerting governance on corporations is, in part, a function of how effective the legal rules are through which the market operates.

This paper looks at a set of capital market–driven corporate governance initiatives and innovations that have been undertaken in emerging markets in recent years and draws tentative recommendations about their effectiveness. Throughout the paper we examine the dynamic between public and private legal rules and their relationship to other factors significant in the development of financial markets.

The events of the past years rival the South Sea bubble and the tulip mania in focusing popular attention on the operations of capital markets and corporations. The full panoply of regulatory and private sector responses has accompanied these spectacular market surges and market failures. The intensity of the activity and its consequences have raised fundamental questions about how capital markets, and financial systems generally, grow and develop and about the role of corporate actors.

There are still more questions than answers. According to Bratton and McCahery,[1]

> 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. Concerns 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

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* An earlier version of this paper was prepared for the 4th Annual Financial Markets and Development Conference, Building the Pillars of Financial Sector Governance: The Roles of the Public and Private Sectors, sponsored by The World Bank Group, The International Monetary Fund, and the Brookings Institute (2002). Parts of this paper also appeared in C. Jordan, "The Conundrum of Corporate Governance", 30 *Brook. J. Int'l.L.* 983.

[1] W. Bratton and J. McCahery, "Comparative Corporate Governance and the Theory of the Firm: The Case against Global Cross-Reference," *Columbia Journal of Transnational Law* 38 (1999): 213–97, quote is found on p. 213.

> 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.

With respect to public legal rules, some beacons are shining through the thicket of discourse, speculation, and experimentation. Legal rules and legal families do matter.[2] Political structures matter.[3] History, how legal concepts are introduced, matters.[4] Legal systems are systems, and legal concepts are not indiscriminately interchangeable components.[5] Forces of convergence and divergence in legal rules operate selectively.[6]

La Porta and others were among the first to turn the spotlight on the relationship between legal rules and the 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 … Legal rules do matter." They looked to the two main legal traditions in developed economies—the Anglo-American common law tradition and the continental European "civil" or Romano-Germanic legal tradition—and concluded that both the level of legal enforcement and the origin of the rules correlated with the level of development of both equity and debt markets.[7] Measures of investor protection appeared superior in common law countries and translated into more vibrant equity markets.

The implication—that common law systems are superior in fostering sophisticated financial systems—was bound to sow controversy and did not go unchallenged for long. According to Rajan and Zingales,[8]

> 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.

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[2] La Porta, Lopez-de-Silanes, Shleifer, and Vishny, "Investor Protection and Corporate Governance," *Journal of Financial Economics (Netherlands)* 1-2 (October/November 2000): 3.

[3] R. Rajan and L. Zingales, "The Great Reversals: The Politics of Financial Development in the 20th Century," NBER Working Paper 8178 (Cambridge: National Bureau of Economic Research, March 2001), p.1-72.

[4] Katharina Pistor, "Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies," EBRD Working Paper 49/2000 (European Bank for Reconstruction and Development, 2000); Katharina Pistor and others, "Economic Development Legality and the Transplant Effect," Davidson Institute Working Paper 410 (Davidson Institute).

[5] Bratton and McCahery, "Comparative Corporate Governance," p. 215; Cally Jordan, "Law Matters: Corporate Governance Legal Reforms in Asia and Their Implications for the ECA Countries," presentation to the World Bank, September 27, 2000.

[6] Cally Jordan, "Experimentation in Capital Markets Regulation" (Montreal: IOSCO, October 25, 2000).

[7] See Bratton and McCahery, "Comparative Corporate Governance."

[8] Rajan and Zingales, "Great Reversals," pp. 1–72.

> 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.

Both arguments 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 undermine them. Legal rules—or, more precisely again, public legal rules—are the product of and dependent on 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:[9]

> 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.

Pistor concludes, "A simple convergence story does not do justice to the complexity of legal change."[10]

Obviously intrigued by the complexity of legal change, Pistor also has looked at what she calls legal transplants or the transplant effect, the relative effectiveness of hybridization. How do legal concepts from one system fare when transplanted to another? Her conclusion here, which is both surprising and not surprising, is 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.[11]

One factor driving the proliferation of legal transplants has been 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, though, have not been picked out of thin air; their legal origins can be traced back to national systems, predominately common law ones. Gauging the effectiveness of convergence to these standards becomes a more complex matter.

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[9] Pistor, "Patterns of Legal Change," p. 4.
[10] Pistor, "Patterns of Legal Change," p. 46.
[11] Pistor and others, "Economic Development Legality."

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—whether statutory or otherwise—are more path dependent, which means they are more resistant to change and the absorption of foreign elements. Corporate or company law, largely a product of the nineteenth century, is one example. The more basic is the legal concept, the longer are its roots and, arguably, the more impervious it is to external change, meaning the forces of convergence. Concepts of contract, status, and property law, for example, reach back hundreds and thousands of years.

And legal rules are part of legal systems; they 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, due to conflicts or incompatibility, at another level. Much of the grief that has ensued in the aftermath of the mass privatizations marking the past decade can be attributed to the indiscriminate mixing and matching of legal rules, a process of transplantation that resulted in dysfunctional or 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 discipline 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 (legislation, regulations, and judicial enforcement) than on private legal rules (contracting, adherence to voluntary standards, and enforcement through arbitration and market discipline), the questions at the heart of the debate apply equally in the context of private rule making. Are some systems superior to others? Are systems of private rule making on a path toward convergence? Is private rule making path dependent? How effective can various mechanisms of private rule making and enforcement be within the overall system of public and private law? To what extent can private rule-making mechanisms be "imported" or "transplanted" between systems?

Whether we are talking about public legal rules, 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 to the form that legal rules take.

As the cases that follow evidence, there has been a blossoming of public and private capital markets initiatives intended to improve corporate governance. Some exciting experiments are under way. One feature of the Latin American experimentation, in particular, is the way in which a combination of public and private legal rules have been mobilized and the significant role played by semi- or quasi-public legal rules. 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 examining such initiatives on a systematic basis and start thinking about what combination of factors is likely to affect the success or failure of the experiments.

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, ex ante and ex post, legislation (enacted through political process), and its enforcement through the judicial system. One conundrum noted by Katharina Pistor in transition economies, for example, was the coexistence of high-quality formal legislation (a product of "an external supply of legal solutions") and low levels of effectiveness:[12]

> 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 in order to understand the remarkable difference in the governance of firms despite the trend towards convergence of the law on the books.

Largely overlooked in this debate has been the role of private legal rules, ex ante and ex post: 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 means of 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.[13] The derivatives markets in the United States are regulated by a combination of private and public legal rules that operate ex ante and ex post and are presented schematically in diagram A:

Diagram 1. Derivatives Regulation Framework

	Private	Public
Ex ante	Contract (ISDA)	Congress (CFMA)
Ex post	Arbitration (NASD)	Courts (SDNY)

[12] Pistor, "Patterns of Legal Change," pp. 46–47.
[13] Frank Partnoy, "SDA, NASD, CFMA, and SDNY: The Four Horsemen of Derivatives Regulation?" *Brookings-Wharton Papers on Financial Services* (Washington: Brookings, January 2002).

His assessment:

> First are private <u>ex ante</u> legal rules developed primarily by the International Swaps and Derivatives Association, Inc (ISDA) 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 <u>ex post</u> legal rules applied by arbitrators in disputes, particularly those of the National Association of Securities Dealers (NASD) … Arbitration has numerous drawbacks, especially uncertainty, and likely will not predominate in future adjudication of derivates disputes. … Third are public <u>ex ante</u> 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 <u>ex post</u> 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.[14]

His conclusion: "The recent trend to privatize legal rules applicable to derivatives is likely to continue."[15]

Private legal rules—contracts—are powerful and pervasive. They are at the heart of any market. Capital markets are not an 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 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; relying on contracts, exchanges ordinarily go no further than delisting or public censure.[16] 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 semi- or quasi-public legal rule.

Contract, too, is at the heart of the corporate entity. Modern U.S. legal theory looks at the corporation as a "nexus of contracts."[17] In the interest of efficiency, corporate

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[14] Partnoy, "ISDA, NASD, CFMA, and SDNY," pp. 2–3.
[15] Partnoy, "ISDA, NASD, CFMA, and SDNY," p. 36.
[16] But see the discussion of mandatory arbitration of shareholder disputes required of companies listing on Level 2 or the Novo Mercado.
[17] According to Pinto and Branson, "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

law—public legal rules—acts primarily to establish a standard form of contract, or default rules, for the organization of corporations.[18] The incorporators themselves, and subsequent shareholders, may vary these rules (and often do) virtually in their entirety by contract in the private or closed corporation. Closed corporations—private companies—are the predominant 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 bylaws and shareholder agreements, in particular, for their operation.

The primacy of contracts in the market also underpins the dominant regulatory approach to capital markets (and, secondarily, corporate governance): the Anglo-American disclosure-based regime. Why is "transparency"—disclosure—so fundamental? It is so important because a guiding principle of the capital markets is still caveat emptor, buyer beware, from the Roman law of the contract of sale. The nature of the public legal rules, these disclosure-based rules, is determined by their deference to the private legal rules of the market.

Contracts are consensual, flexible, and, optimally, both self-enforcing and *independent of political process*. Each characteristic can vary in degree, but the consensual nature of contracts is their defining characteristic. Standard-form contracts, rife in the securities industry, are largely inflexible, either for the sake of predictability and convenience or for the superior bargaining power of one party, but they are still consensual. Bylaws or industry association rules are a variation on standard-form contracts.[19] In becoming a member of the organization or company, the member agrees to abide by the rules. Contracts thus form the basis of so-called self-regulatory organizations so prevalent in the Anglo-American securities industry.

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

A Framework for Capital Markets and Corporate Governance Rule Making

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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." A. Pinto and D. Branson, *Understanding Corporate Law* (New York: M. Bender, 1999), p. 115–16.

[18] In the United Kingdom and many other 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 in order to benefit from limited liability and legal personality. The contractual basis of the company has long been a theoretical impediment to the creation of one shareholder company; it takes two to tango and two (at least) to contract.

[19] The derivation of the word bylaw is interesting in this respect. 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. *Shorter Oxford English Dictionary.*

The cases that follow represent a variety of experiments in public and private rule making in a set of significantly different emerging markets. The set of cases we have included is not comprehensive or 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 diagram 2, some useful observations can be draw. Accordingly, the cases cover instances of "pure" legal reforms, "pure" issuer-investor contracting, government sponsored "voluntary" codes, a mandatory disclosure regime, optional listing standards, and the use of ratings.

Diagram 2 takes as its starting point the two-by-two matrix of public versus private ex ante and ex post rule making developed by Partnoy to describe derivatives regulation. However, applying the same strict public-private dichotomy would, in our view, oversimplify the typology of capital markets–driven corporate governance initiatives that have been introduced in recent years in emerging markets. Accordingly, we have added a column to provide a home for mixed private-public rulemaking. This facilitates separate treatment of those contractual arrangements that are made "freestyle" (negotiated on a case-by-case basis between companies and stakeholders) and "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.

Diagram 2. Corporate Governance Framework

	Private	Quasi-private, quasi-public	Public
Ex ante	Contract	Sponsored "voluntary" standards	Law or regulation
Ex post	Arbitration	Special arbitral bodies	Judicial

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 element that may not fit neatly into a single box. This is probably evidence of both the ingenuity of the reformers and the value of using a mix of public and private legal rule making to address issues of corporate governance.

Case 1: Legal Reforms—Latin America

When corporate governance issues become popular fodder for the national press, as they have in both Organization for Economic Co-operation and Development (OECD) and emerging markets, it is unusual for the legislature to remain completely quiescent. Falling most squarely into the right-hand column of diagram 2 are the numerous reforms of company laws and capital markets legislation undertaken in emerging markets over the past five years. In Latin America alone, high-profile amendments to the legal-regulatory

framework have become law in all the major markets.[20] Smaller markets are following suit.[21]

Scandals: The Impetus for Reforms

The reforms of Latin American company and securities law typically were conceived in the aftermath (or sometimes during the course) of scandals in the public securities markets involving perceived inequitable treatment of shareholders. In Chile there was the Enersis debacle, where the managers and controllers of a power company managed to secure fully one-third of the total price paid for control 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 repeatedly, and 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 had decided to delist the companies. And the vast majority of Brazilian shareholders (most of them holders of nonvoting "preferred" shares) felt themselves unfairly frozen out of transactions in which those holding a majority of the voting shares sold control of the company.

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 following the amendment of the legal framework. One problem with efforts to reform company law is that company law generally is applicable to all companies similarly situated (for example, all listed companies must comply). It is not surprising that the recent spate of Latin American legislative initiatives failed to receive the unanimous support of the business community. Typically, established firms with proven track records in the market or dominant positions in the equity indexes were not 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 debates over reform, 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.

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[20] 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).

[21] Colombia, draft securities act presented to Congress January 2002 (derivative actions, liability of controllers, tender offers).

But not all securities issuers, or potential issuers, resisted the reforms. 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 prior to 2001.[22] A major Mexican transgressor was the first company to adopt the Mexican code of best practices in an effort (so far unsuccessful) to turn around its reputation for trampling on minority shareholder rights. The less resistant firms typically expected heavy capital-raising requirements in the short to medium term.

In the end, the legislatures and executives in Latin America approved legislation that was a more or less watered-down version of what was initially proposed. Chile's reformers were perhaps the most successful, but even there, majority shareholders were permitted to suspend application of the law's mandatory tender-offer provisions for three years. Mexico's legislation (probably unwisely) delegated authority for setting the parameters of the mandatory tender-offer rule to the banking and securities regulator, which has so far proven unable to issue the required regulation. 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 fiscal boards[23] similar independence from controllers had to be dropped.

Early Results: Mixed

The promoters of the recent legislative initiatives in Latin America, and elsewhere in emerging markets, 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 effect on capital market development. 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. It will take at least two or three years before there is enough solid data to test the hypothesis that the reforms helped to 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 an investment strategy of buying minority voting shares in Brazilian firms.)[24]

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

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[22] See the discussion of Ultrapar in case 2.
[23] *Consejos fiscais* are independent organs of corporate governance similar in many respects to the French *comisaires* or the *sindicos*, *comisarios,* or *revisores fiscales* required or permitted under the law of other Latin American countries.
[24] Deutsche Bank Latin America Strategy, November 5, 2001.

to the health of the capital markets (and, by extension, the pension savings regimes). The battle lines have been drawn, and the public now knows whom to root for. Although it is hard to judge just how much the legal reforms encouraged the development of private contractual arrangements discussed elsewhere in this paper, the interrelation between the Brazilian legal reform and the emergence of the Novo Mercado and the Colombian experience with Resolution 275 (both described below) tend to support the conclusion that legal reforms can accelerate the development and adoption of complementary or supplementary private contractual mechanisms.

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 governance discount as a result of passage of the reforms. Controversial delistings and changes in control accelerated during 2001 and continue today. Controllers may 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). And the impetus created by the legal reforms for voluntary private contracting does not 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 (ADR) programs, and those with large pension fund stakeholdings have begun to improve their overall practices. However, Santiago’s tightly knit community of chief executive officers and directors has not experienced an epiphany. There has been no 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 so far have fizzled.

Case 2: Ad Hoc Contracting, 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—as, for example, that the company’s voluntary practices will be in line with evolving market standards and expectations—may be more subtle (and less easily enforced). As investors 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 Professor Partnoy’s observation on the trend toward “privatization” of legal rules. Two recent Brazilian initial public offerings (IPOs), one for ADRs prior to passage of the legal reform and the launch of the Novo Mercado and another for the first listing on the Novo Mercado, illustrate this tendency.

Issuer-Investor Negotiation: Tag-along Rights

Ultrapar is a large Brazilian liquefied petroleum gas and petrochemicals distribution company. Its 2001 total sales amounted to almost $1 billion. As of March 1,

2002, its market capitalization exceeded $460 million.[25] Ultrapar decided to test the international market in 1999, offering nonvoting shares to U.S. investors through a sponsored ADR program listed on the New York Stock Exchange (NYSE). 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 ago 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.

Despite Ultrapar's history of good shareholder relations, investors expressed concern during the ADR road show 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. Clearly, an investment in Ultrapar would be in part a "takeover" play. 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 its 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, the purchaser of a controlling interest did not have to 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 to 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 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: Conflicts of Interest

The very recent case of Companhia de Concessoes Rodoviarias (CCR), a highway concession manager in Brazil, is similarly one of the 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 5,

[25] Ultrapar's annual report.

described below), 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 (which 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 on 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 qualifications for Novo Mercado: one-share, one-vote; tag-along rights; international accounting standards, independent directors, arbitration of shareholder disputes, and so forth. 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. After the first draft of the company's prospectus was vetted, 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 $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 $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, Novo Mercado rules of the São Paolo Stock Exchange. Institutionalized contracting arrangements like Novo Mercado can grow out of shared experiences with ad hoc contracting. Conversely, the CCR case demonstrates that institutional mechanisms like the Novo Mercado can also be supplemented by ad hoc arrangements that take the "packaged" institutional arrangement as a basis on which to build an appropriate company-specific governance structure credible in the markets.

Case 3: "Voluntary" Codes, Mexico and Russia

Most practitioners understand a national code of best practices as 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, the government has taken the lead role, either jump-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 (2000)[26] and the Russian code of corporate governance (2002) illustrate each approach.

Mexico: Jump-Starting a Code

In the aftermath of the collapse of the Mexican banking sector in 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 Nacional Bancaria y de Valores (CNBV), Mexico's banking and securities supervisor, launched an initiative to draft a code of best practices for corporations. 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 selected well-known academics and representatives of the legal community to participate.[27] From the start of the process, it was expected that public companies would be required to disclose on a periodic basis 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 of drafting 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 a series of informational public meetings was held during the first half of 2001, the discussions at such meetings had little 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 or regulatory framework. An early draft of some of the code's chapters indicated that the document likely would not be clear about which of its provisions were restatements of existing law, which represented FCSM interpretation of the existing legal or regulatory framework, and which were to be regarded as mere oratory.

Throughout preparation of the code, the FCSM gave the market every indication that, unlike most national codes, which for the most part establish general guidelines of behavior, the Russian code would be quite prescriptive concerning the conduct of

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[26] *Código de Mejores Prácticas Corporativas,* available from the website of Mexico's Business Coordinating Council (*Consejo Coordinador Empresarial*)—www.cce.org.mx.

[27] The result was a set of guidelines focusing largely on the quality of financial information and disclosure and the composition and functioning of boards of directors. The code requires finance, compensation, and audit committees, with audit committees being composed of a majority of directors independent of management and controllers.

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 chairman of the FSCM made repeated public statements to the effect that the code would provide Russian companies with guidance on how the authorities would enforce the country's company and securities legislation. Although the chairman of the FCSM announced that the code drafting process was formally completed in December 2001, copies have not yet been made available to the public.

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 more toward the right column of diagram 2—legal prescriptions to be enforced in the courts (or through administrative action)—or more toward the left column? Or should it be regarded as a mix, with ex ante characteristics of legislation (rules established by the government), but leaving enforcement mostly to private means? The ultimate answer in any particular case probably depends largely on the approach the regulator takes to enforcement and the courts take to interpretation. Regulators that jump-start the code-drafting *process* and not its content or enforcement (as in Mexico) may accelerate the emergence of appropriate benchmarks for good governance—that is, 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), 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 the development of more voluntary initiatives and indeed even for the development of public discourse on the topic of corporate governance.

Case 4: Legal Investment Disclosure Regime, Colombia

Both OECD 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 frequent evolution has been to follow the approach taken in connection with the U.K. combined code. A committee representing some mix of the business community, investors, intermediaries, and government draws up a code of best practices, and by law, regulation, or custom public companies are required to disclose the extent to which their practices differ from the code. Individual companies may respond by adopting the national code as their own (formalizing this through their board of directors or shareholder ratification) or by devising 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 Colombian corporations. From the start of the Superintendency of Securities' preparation of a new capital markets law for presentation to Congress, the superintendent insisted that the law had to directly address perceived problems with enforceability of shareholders rights, transparency, board practices, and director and controller liability.[28] 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, which represented the country's principal institutional investors.[29] 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 prescribing rules for issuers whose securities (both debt and equity) are to be eligible for purchase by Colombia's pension funds.[30] 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 much in the way of specific shareholder protection, board practice, transparency, or enforcement provisions to be included in company charters.[31] Rather, Article 3 states that, in order for a company's securities (equity or debt) 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.[32] Articles 4, 5, and 6 then require that such 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 of all Colombian listed companies (in practice, companies without access to the pension fund market are unlikely to achieve much liquidity in their shares or to issue new securities).[33] It lets companies themselves (and the market) interpret the meaning of

[28] In anticipation of further private sector initiatives, the draft law included specific legal authorization for corporate governance rating agencies.
[29] The results of the Confederation of Chambers of Commerce's Corporate Governance Project can be accessed through its website: www.confecamaras.org.co.
[30] Law 100 of 1993, Article 100, sections 3 and 4.
[31] Article 7 of the resolution does, however, require that companies achieve at least a 20 percent public float in their share within four years of the resolution's effectiveness.
[32] 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.
[33] In contrast, Chile's laws and regulations governing pension fund investments have always imposed substantive requirements on eligible companies, including the requirement that a certain portion of a company's income must derive from its core business (anti–holding company provision) and that pension

"specific mechanisms," 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. It also injects the potential for perhaps 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. This 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, the 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 listed companies will not formally present their codes to shareholders until this year's season of annual general meetings, many codes have already been approved by the board of directors and made available on the companies' websites, through the media, and directly to pension funds.[34] 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 Articles 3 and 4 of the resolution. Investors now have a clearer and more concise statement of suchcompanies' policies and practices, but, in the case of companies that have issued "compliance-type" codes, there have been 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. In a number of cases, company management (sometimes with the help of outside governance consultants) drafted codes organized more along the lines of the OECD Principles of Corporate Governance than those of Resolution 275.[35] Although there is a fair diversity of style and content among the codes that have been made available to the public so far, some of them clearly do 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

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funds may not vote for board members whose election is accomplished with the collaboration of controlling shareholders.

[34] A few issuers, generally large financial institutions, already had published corporate governance policies that required little adaptation to meet the requirements of Resolution 275.

[35] One code even cites the words of Mohandas K. Gandhi as an inspiration.

[36] Given the circumstances surrounding their birth, all the Colombian codes issued in the aftermath of Resolution 275 should be placed in the center column of diagram 2, with compliance-type codes placed more toward the right (public) column, and more shareholder-friendly and board-professional codes placed closer to (if not actually in) the left (private) column.

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 shareholder 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 (that is, one share, one vote). At least four of the ten board directors must be independent of management and controllers. The company's board is required to have audit, compensation, and governance committees, with the audit committee dominated by independent directors. Perhaps most significant, Article 1.1 of Inversura's code provides that disputes between shareholders and the company will be submitted to arbitration by the Commercial Arbitration Panel of the Chamber of Commerce of Medellín.[38]

Prospects

Colombian institutional investors report that Resolution 275 has had positive effects on transparency. All companies that want their shares to be actively traded must be explicit about what charter provisions and company policies exist in key issues of shareholder protection, board practices, and disclosure. The resolution has helped to move corporate governance up the public agenda and garnered a great deal of public attention. Indeed, Resolution 275 has accelerated the 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. One reason it has been possible is precisely the lack of prescription and the opening for voluntary initiative that Resolution 275 presented to the private sector.

How well companies will comply with their new codes and how enforceable their obligation to do so in the longer term are still to be seen. 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

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[37] Inversura, although not a public company, 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 follow suit, solidly within the left column of diagram 2—private voluntary contracting between companies and investors enforceable by private means.

companies. It will be particularly interesting to follow the development of the initial codes over the next few years. Will issuers compete 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 takes a progressive stance and another set that is 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 be the contribution to capital market development? It will require at least a few years before any firm conclusions can be drawn.

Case 5: Stock Exchange Listing Rules, Brazil's Novo Mercado

The requirements of NYSE listing rules for independent directors and audit committees are often cited as an example of the positive role that self-regulatory organizations can play in improving the standards of corporate governance. However, prior to the mid-1990s, many stock markets in both OECD and emerging markets resisted calls to impose higher standards with respect to shareholder rights or board composition. This resistance was grounded in a concern that listing rules going beyond the minimum requirements of local company law might discourage new listings, particularly by start-up, founder-controlled companies. Most established listed companies were less than anxious to change their practices. As in the case of 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 São Paolo Stock Exchange (Bovespa), conceived in late 2000, traces its roots to the efforts to reform Brazilian company and securities legislation discussed in case 1. It 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, avoiding the "one size fits all" problem, 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: (1) market capitalization and trading volumes in the public equities markets were contracting dramatically, and (2) 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.

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. Although these disturbing trends were attributable to many factors, the perception by domestic and international investors that corporate governance practices of

Brazilian companies were generally poor and legal protections were inadequate (particularly with respect to minority shareholder rights) called for some sort of response.[39]

The compromises 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 legal reforms were unable to address certain well-understood and objectively determinable shortcomings of existing law and that this could provide the basis for a voluntary rules-based response. Bovespa's initiative can properly be called a "privatization" of at least part of the reform process.

Different Strokes for Different Folks

The Novo Mercado is a listing segment of Bovespa for companies choosing to commit themselves to the highest standards of corporate governance by contracting to follow a stricter set of rules.[40] In addition, Bovespa created two intermediate listing segments, the Special Corporate Governance Level 1 and Level 2. The listing rules of the Levels 1 and 2 also require higher standards of corporate governance but are not as strict as those 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 choose among four listing segments, in ascending order of corporate governance standards: the old market, Level 1, Level 2, and the Novo Mercado.[41]

By committing themselves to higher standards of corporate governance, companies that join the Novo Mercado intend to distinguish themselves in the eyes of investors in the hope that investors will place higher valuations on their securities, reducing the general corporate governance discount applied to Brazilian firms.[42] The creation of Level 1 and Level 2 was a bit of an afterthought. Under pressure from their

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[39] McKinsey Global Investor Opinion Survey, 2000. The president of Brazil's securities commission (Comissão de Valores Mobiliarios—CVM) took a leading role in the effort to reform the company and securities law precisely because he shared the view that, although improvements in corporate governance of Brazilian companies would not by themselves effect a recovery of the equity market, they were a necessary condition.

[40] www.novomercadobovespa.com.br/english/index.htm.

[41] 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 is designed for companies from the technology, media, and telecommunications (TMT) 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.

[42] The most exigent of the Novo Mercado's rules is that (a) nonvoting shares may not be issued (one share, one vote). The other main requirements are (b) to hold public share offerings through mechanisms that favor capital dispersion; (c) to maintain a free float equivalent to 25 percent of the outstanding stock; (d) to provide all shareholders with the same conditions provided to controlling shareholders in the transfer of the controlling bloc (tag-along rights); (e) to hold a tender offer by the economic value criteria should a decision be made to delist from the Novo Mercado; (f) to establish a single one-year mandate for the entire board of directors; (g) to make the annual balance sheet available in accordance with U.S. generally accepted accounting principles or international accounting standards; and (h) to improve the quarterly reports to include consolidated financial statements.

base of existing listed companies, Bovespa had to offer something that would allow such companies to avoid appearing indifferent to investor concerns.[43]

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, facilitating the enforcement of arbitral awards.) 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.[44]

Any Takers?

Since Bovespa launched its corporate governance initiative, several public and quasi-public entities have introduced actions to support the Novo Mercado and the two levels. 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. The listing rules of the Novo Mercado were officially launched in December 2000, but it was not until February 2002 that CCR became the first company to have 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 has joined Level 2 (although several have announced their intentions 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 already adhering to Level 1 includes several companies with doubtful corporate governance credentials, which are willing to disclose more information but may have little intention or incentive to advance to Level 2.[45]

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[43] Level 2 has almost all the same rules as the Novo Mercado, but with the notable exception that Level 2 companies may still have nonvoting shares. Level 1 relates mainly to transparency and disclosure, rather than shareholder rights. It is doubtful whether adherence to Level 1 shows a real improvement in corporate governance; rather it should be a first step before more substantial changes are made.

[44] The Market Arbitration Panel appears to represent a significant shift of power to shareholders and is perhaps the greatest single obstacle to convincing companies to adhere to Level 2.

[45] These disappointing results can be explained almost entirely by the economic scenario and market conditions prevailing in Brazil in last eighteen months. With international problems, namely, the Argentine situation and the decline of the U.S. stock markets, combining with a domestic energy crisis, this period has seen prolonged uncertainty for the Brazilian capital markets. Since late 2001, the prospects for Brazil have been improving, but it will take some time for confidence to recover after the long period of uncertainty. During this period, interest rates rose, when they were initially expected to fall. This made the stock market a relatively expensive source of outside capital for companies. Against this background, it is not surprising that BOVESPA did not see any IPOs during 2001, either on the Novo Mercado or on the other listing segments. At the same time, numerous companies have made public announcements that they plan to

Case 6: Ratings

Corporate governance ratings can be characterized as an implicit private contract between a company and investors, semi-enforceable through private means (the left-hand column of diagram 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 performing its part of the bargain. If the company subsequently fails to maintain its rating (which may involve a combination of a scoring of the company's charter and practices and an evaluation of its relative position within the market), the company is penalized by reputational damage and, in theory, a consequent decline in the market value of its securities.[46]

Certain factors of corporate governance (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 for the conduct of ratings of corporate governance has yet to emerge on a stand-alone basis. Instead, in both OECD and emerging markets, we 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. 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.[47] Certain other markets in East Asia are currently debating whether to follow Thailand's example. The drafters of the first corporate governance code in Poland, the Gdansk Institute for a Market Economy (CIME), a respected Solidarity-affiliated think tank, produced a set of ratings for a subset

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migrate to Level 1, to Level 2, and, in the case of a few companies with only voting shares, even to the Novo Mercado. Several private companies have announced general plans to have Novo Mercado IPOs in the future. Now that there has been one Novo Mercado IPO, it is anticipated that all future IPOs will be on the Novo Mercado. Investors would look very unfavorably on IPOs on the other listing segments.

[46] The analogy between rating institutions and private arbitration breaks down at this point, since the rating agency cannot require that the company compensate the investors for losses resulting from its violation of the implicit contract. However, as in the case of credit ratings, failure to maintain a corporate governance rating could conceivably trigger events of default under loan agreements or make the company ineligible (or less eligible) for investment from some sources (such as pension funds).

[47] 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.

of companies on the Warsaw Stock Exchange earlier this year. CIME intends to publish a fuller set of ratings later this year. Ironically, CIME'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. Warsaw Stock Exchange or the Polish securities regulator are expected to require that each listed company disclose on an annual basis the extent of its compliance with the Warsaw Stock Exchange–sponsored code rather than with the CIME code.

National shareholder rights groups have also undertaken rating initiatives. One of the best known such group, 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 not-for-profit institution and makes public its basic company ratings. 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 Commercial Business Plan

For-profit commercial corporate governance rating services for emerging markets appear still to be searching for a business model that will prove viable in the long term. Some efforts, such as CLSA's in Europe and Deutsch Bank Alex. Brown's recently launched global effort out of New York, are operated in close association with general equity research and analysis. Standard and Poor's Corporate Governance Rating Service, although active in only a few markets, intends to operate as a stand-alone business. As in the case of its credit ratings business, S&P's customers are expected to be mostly the rated issuers themselves, and, as in the case of equity research services, the results will usually be published. S&P hopes that companies with good governance will use an S&P rating as a vehicle to communicate this to investors. It is hoped that S&P's 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.[48]

In contrast, a new company, Governance Metrics International, seeks to provide investors with corporate governance ratings for companies across entire markets, both in OECD and non-OECD countries. Although the service has not yet been launched, its sponsors have developed a methodology that incorporates evaluation of both company-specific data and country-specific data to produce scores that they contend can be compared between companies both 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

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[48] One consequence of the S&P business model may be that it results in less than complete coverage of each market since only a handful of companies are likely to elect to incur the expense of securing a rating in any given emerging market.

viable, enough elements of the methodology would become well enough known in the markets that some companies would take steps in hopes of receiving a higher score.

What Flowers Will Produce Fruit?

Each of the approaches to corporate governance ratings described above (and the typology presented is not intended to be exhaustive) has its virtues and limitations. How effective any one system of ratings can be as a system of private quasi-contracting will depend 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. Some indications of whether, in fact, corporate governance ratings of some sort have a future might include their employment in loan covenants, legal investment rules (for example, for pension funds), and the formulation of market indexes.

Observations: Implications for Capital Markets and the Governance of Corporations

Although it is too soon to make definitive judgments about "what works," several general observations can be made about the role of private and 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 semi-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 will depend on a variety of factors. Some of the most effective mechanisms may be found in these intermediate forms—semi- or quasi-public legal rules—enforceable by private means.

Private Legal Rules Are Important

The regulation of capital markets and the governance of corporations has been very much an Anglo-American debate over the past several years, and it is not surprising that 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 (for a variety of reasons),[49] it has been the daily bread of lawyers and accountants for 150 years.

Over that time, fairly standardized private legal rules developed and dropped into negotiated partnership contracts, shareholder agreements, and private company bylaws to balance and protect the ongoing economic interests of participants and, if necessary, provide for exit from the enterprise and dispute resolution without recourse to the courts. In commercial matters, the courts would be a last, and undesirable, resort.

Particularly in the United States, these contractual governance mechanisms were transformed into public legal rules, applicable often on a default basis[50] for private or closed corporations. These include cumulative voting to ensure board representation for minority shareholders, tag-along rights in case of change of control, puts 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, and arbitration and nonjudicial dispute resolution. Some of these contractual governance mechanisms were adapted and crossed over to the realm of public corporations. Their outlines can be seen, for example, in the 1964 Williams Act in the United States, which is the source of U.S. tender-offer rules.

These contractual governance mechanisms figure prominently, in different forms, in the Latin American case studies. Private legal rules—contracts—are important in and of themselves, but they also are 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 Professor Partnoy observes, again over time, 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 in Terms of the Effectiveness of Private and Public Legal Rules

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 over 200 years ago at the time of the American Revolution and in some interesting respects has greater affinities with the continental European tradition than with English common law.

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[49] Including U.K. privatizations of the 1980s creating a base of vocal shareholders wielding political power, the tabloid scandals of the Maxwell affair, outrageous U.S. executive compensation, and the glamorization of Wall Street.

[50] That is, not mandatory. 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).

The American and English common law traditions share their heavy reliance on ex post public legal rules: the courts. As every student of common law 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 traditions with great importance.

In English common law, the importance of judicial action—case law and ex post public legal rules—continues to dominate even statutory, or written, law—the ex ante public legal rules. The English common law system demonstrates to this day a surprising aversion to law as legislation; that is, to ex ante public legal rules. Large and complex swathes of English law are found in no written legislated form. Trust law, from which is derived the concept of fiduciary duties, is a prime example; its fundamental principles remain judge-made, their source being ex post public legal rules. In some cases, there are no judge-made rules—public legal rules—at all. England has no written constitution, for example; in its place are parliamentary conventions, which are practices and principles developed over long periods of time and operating on a consensual basis.[51]

The American legal tradition shows no such aversion to the use of legislation—ex ante public legal rules; 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[52] (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—ex ante public legal rules, particularly as embodied in the great nineteenth-century civil and commercial codes. These are, literally, "pays du droit ecrit," a "country of written law" being a term of art identifying a certain legal tradition. If, in the common law world, there is no right without a remedy, then in the continental European tradition, it would be fair to say, 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: constitution/code/statute/regulation. Like a game of cards, a provision in a civil or commercial code will always trump a statute, a piece of specialized legislation.

A Predictor of Effectiveness of Any Particular Governance Mechanism May Be Its Form (Private, Public, or Semi-Public Legal Rule) and the Legal Tradition in Which It Operates

This has not been idle dalliance in the fascinating but irrelevant backwaters of comparative law. The effectiveness of a governance mechanism in a particular legal system will be related to the form it takes. 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

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[51] What a way to run a country, some might say.

[52] About the link between the uniform commercial code and the German commercial code.

matter. Pistor is correct: the manner in which a legal concept is introduced or transplanted matters. And the form that a rule takes also matters. Some of the otherwise "inexplicable" consequences, the 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. Codes of corporate governance probably were the most popular governance mechanism of the 1990s, proliferating around the world irrespective of legal tradition, pattern of corporate ownership, or level of development of the capital market. They trace their immediate origins to the 1992 U.K. Cadbury Report.

No one would question the extraordinary influence of the Cadbury Report in spawning a worldwide interest in corporate governance and the mechanisms to promote it. In its country of origin, the United Kingdom, the current manifestation of the Cadbury Report and subsequent recommendations is the 1998 combined code on corporate governance.[53]

The most significant feature of the combined code is that, contrary to the implication in its title, it is not written law. It is a voluntary code. In the continental European tradition, a voluntary code is an oxymoron. A code, by definition, is written law (ex ante public legal rules), meaning a written body of laws so arranged as to avoid inconsistency and overlap.[54]

What kind of creature is the combined code if not legislation? It is a code in another sense: "a set of rules on any subject, *esp*., the prevalent morality of a society or class; an individual's standard of moral behaviour."[55] It is one of the weakest forms of private legal rule, if that; it is no more than a set of guidelines missing 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, How effective can the combined code possibly be, and why choose this form? To deal with the first question, the combined code can be reasonably effective in the United Kingdom, all things being equal. Remember, the United Kingdom relies on unwritten parliamentary conventions in lieu of a written constitution and has a respectable, if now fraying, tradition of using moral suasion as a regulatory technique.[56] The combined code is not the only voluntary code either; the U.K. City code on takeovers and mergers is not written legislation; it too is a voluntary code.

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[53] Committee on Corporate Governance, "The Combined Code" (London, 1998).
[54] OED.
[55] OED.
[56] Tea with the governor of the Bank of England, for example, prior to recent regulatory reforms.

As to the second question, why this choice of form, the answer is more elusive. It is not as though the United Kingdom were emulating an existing model elsewhere. 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.[57] We characterize these rules as semi- or 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. The origins of the audit committee recommendation can be traced even further back to its legislative form as an ex ante public legal rule. In 1975 the Canada Business Corporations Act introduced a provision making 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 also was subject to the influences of the Quebec civil code (itself based largely on the French Napoleonic code) regarding legislative approach and drafting techniques, with its continental European bias in favor of written law (ex ante public legal rules). So we have one rule, but three different, albeit related, manifestations. What is their relative effectiveness?

This brings us back to the question, Why choose a voluntary code? A number of virtues can be cited: flexibility, responsiveness, and sensitivity to industry-specific concerns and considerations, the usual virtues of private legal rules. Underlying these rationales, though, the peculiar British aversion to written legislation (ex ante public legal rules) also shines through. And even subtler forces may also be influencing the form these rules have taken in the United Kingdom.

The Cadbury Report focused on the composition and responsibilities of the board of directors. The directors of English companies, like their American counterparts, are subject to fiduciary duties derived from ancient legal concepts of trust law. Early nineteenth-century English business enterprises, predating the various company laws enacted over a period of several decades, were organized as trust vehicles with the roles of director being assumed by real trustees. Trustees are subject to strict fiduciary duties of fair dealing, impartiality, and accountability, which, due to a quirk of medieval history, were enforced by a separate *ecclesiastic* court system, the Courts of Equity. Fiduciary obligations are triggered whenever there is a separation of ownership from management of property and are carried over to the obligations of directors because of the separation of ownership and management resulting from the shareholder-director structure of the company. Enforced by the Courts of Equity (literally, the court of fairness), fiduciary duties are suffused with moral righteousness. What more appropriate vehicle could there be than one establishing "a standard of moral behavior," a voluntary code.

The specificity to the United Kingdom of the choice of a voluntary code of corporate governance is obvious. The question then becomes how effective as a delivery mechanism would such voluntary codes be elsewhere. Would they transplant well, even

[57] For example, the audit committee was introduced in 1978.

if voluntarily adopted,[58] and why have they been so immensely popular? Would they transplant at all to continental European legal systems or the complex hybrid legal systems of Asia (legal families matter)? It would be hard to imagine the French (or the Americans, for that matter) jettisoning their beloved constitution, resting at the pinnacle of French ex ante public legal rules, for a variant of English parliamentary convention. The sorry saga of the new Russian code of corporate governance described above indicates the confusion and muddle (Is it law or is it not?) resulting from the unhappy attempt at dropping a voluntary code into an essentially continental European system that cannot recognize the concept.

Voluntary codes and international capital markets. 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 contradict provisions in the civil or commercial code (in which case, the newer elements are simply rendered ineffective by the older codal 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 the governance of corporations. By deliberately introducing an ineffective, but internationally recognized, mechanism for delivering corporate governance, political interests may divert attention away from approaches that would be more effective but also more disruptive to the cozy corporate-political status quo.[59]

How effective is the voluntary corporate governance code in Germany referred to at the beginning of this article? Perhaps the editorial writer at the *Financial Times* was justified in expressing skepticism about the prospects for change.

However, as ineffective as such a mechanism may be domestically in raising the level of corporate governance, it may also have a signaling effect in the international markets. To the extent that corporations participate in the international capital markets (which may catch only a tiny fraction of a country's corporations), other more effective corporate governance mechanisms would be engaged (foreign listing rules and 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 introducing a domestically inappropriate, but internationally recognized, corporate governance mechanism.[60]

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[58] See Pistor, "Patterns of Legal Change."
[59] See Rajan and Zingales, "Great Reversals."
[60] 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 has little interest in a voluntary code of good corporate governance or judicially oriented shareholder remedies (ex post public legal rules). As the head of the Centre des Etudes Juridiques et Judiciaries 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

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 are U.S-origin, procedural mechanisms designed to enhance minority shareholder representation at the board level and to promote management accountability. They are mechanisms whereby public investors in the capital markets may exert direct influence on the governance of corporations.

Again, the primary virtue of such governance mechanisms is their ability to signal international capital markets. U.S institutional investors recognize the signal: the domestic market has become aware of and taken up the corporate governance debate. Cumulative voting and class actions are like little flags attracting the momentary attention of the international capital markets. As an effective mechanism for promoting better governance in the corporate sector domestically, however, the experience is likely to prove disappointing. It is the wrong form of legal rule for most of the legal systems in which they have been transplanted, possibly by the wrong method.[61]

The introduction of cumulative voting and class action in Korea provides an example. The Korean legal system has been strongly influenced by German models via Japan; it prefers ex ante public legal rules (written law) and structural governance mechanisms creating, in theory, a balance of power among the constituents. As in the other legal systems with which it shares its heritage, procedural rules and reliance on ex post public legal rules (judicial recourse) are limited in their effectiveness.

Cumulative voting originates in private legal rules (corporate charters or bylaws) as a procedural mechanism—and a cumbersome one at that—for providing minority shareholders a means of pooling their votes in order to ensure some degree of representation on the board of directors in the absence of a statutory right to direct representation. It is a compensatory mechanism for overriding the principle of majority rule, whereby a majority shareholder can elect an entire slate to the board. In the United States, cumulative voting passed from private legal rule to statutory formulation, where, in the interests of protecting minority shareholders, it was a mandatory feature in many state laws. Over time, however, with a shift to more manager-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. Cumulative voting was made "permissive," not "mandatory," and ultimately was left to the corporate charter.

German corporate law, in contrast, has long provided a statutory mechanism to ensure that certain constituencies have direct representation on supervisory boards. This mechanism is a statutory right to direct representation.

(international activity more likely to be focused on France and Italy), there is little need to send a signal to the international capital markets.

[61] Adoption of cumulative voting and class actions has often been highly recommended or otherwise "imposed" by international financial institutions.

In the aftermath of the 1997 Asian financial crisis, Korea acted quickly to reestablish confidence in its markets; among other things, waves of corporate law reforms, including cumulative voting provisions, were enacted, some at the suggestion of the international community of financial institutions. The cumulative voting rules adopted, though, were of the weak or quasi-public variety. They were not mandatory and could be bypassed in the corporate charter. Although Korean academics had queried, prior to enactment, the effectiveness of these optional or default rules, international advisers had 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 rules ineffective. Once again, it was the wrong rule and the wrong form.

Class actions present even less likelihood of effectiveness as a governance mechanism in most transitional or emerging markets. At least with cumulative voting, there would be a chance of developing rules that could, technically, work in the context of corporate legislation to which they are not native. Class actions, however, fall squarely into the category of ex post (public legal) rules dependent on 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."

So-called class action provisions dropped into the corporate law, as they sometimes are, of transitional or emerging market economies land dead on arrival. There are no procedural rules or institutions to support them.

Public Policymakers Should Anticipate, and Encourage, Private and Quasi-Public Rules That Complement and Reinforce Legal Rules of Corporate Governance

The relationship between 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 practically every case we have studied, efforts to improve corporate governance in an emerging market involved simultaneous or sequential initiatives in the public and private sector spheres. 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 by quasi-public entities like Bovespa and positive examples of ad hoc contracting. In addition, the fully private Brazilian Institute of Corporate Governance has also played an important part in the corporate governance dialogue, developing a voluntary code of best practices and an active training program for companies and corporate directors.[62] As described in cases 1 and 5, the legal reforms anticipated private efforts like Bovespa's Novo Mercado and reinforced the legal status of private arbitration. The Novo Mercado concept was developed in the course of the legislative haggling over the legal reform, so Bovespa was able to privatize more quickly those parts

[62] www.ibgc.org.br.

of the reforms that encountered the greatest resistance and had to be dropped before passage.

Colombia probably represents the clearest example of policymakers and private sector representatives recognizing the value of complementary public and private legal efforts. Almost from the start, the quadrilateral of the securities regulator, the paramount company organization, the stock exchange, and the pension funds association engaged in active consultation and cross-support. There is little doubt that this collaboration accelerated the visibility of corporate governance 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 shareholder 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 are likely to be different.

In the other countries covered by the cases, the interrelation of efforts in public and private law 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 more closely associated with government, the other more distant. An aggressive private sector response in Chile and Mexico has been less evident. Both of these countries historically have had exceptional access to international capital markets. It is possible that this has encouraged complacency among the companies at the commanding heights of the economy 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, while Mexico's industry is still nascent and invested almost exclusively in government securities.

As stated in case 1, the legal reforms already undertaken have not yet produced the effects their supporters hoped they would. However, there appears to have been a qualitatively better early response from companies in countries like Brazil and Colombia (through adhesion to special listing rules in Brazil and adoption of company codes in Colombia) where policymakers anticipated quasi-public and private legal mechanisms. Accordingly, one of the tentative lessons of recent experience is that policymakers should anticipate complementary private sector initiatives and do what they can to make the public legal framework accommodate them. However, policymakers cannot expect to be able to predict with any certainty what kinds of quasi-public and private initiatives will emerge and which will be successful. The cases we have studied yield no template of how best to fill in the spaces in diagram 2. Rather policymakers would be wise to retain the flexibility to reinforce effective quasi-public and private law initiatives as they emerge.

It would be surprising if even within a single market the effective combination of mechanisms remains static. While emerging markets are 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 will need to follow developments carefully and retain the flexibility to respond when necessary to encourage and accommodate effective private rule making.

The Optimal Content and Mix of Mechanisms in Any Market Will Depend on a Variety of Factors. Some of the Most Effective Mechanisms May Be Found in These Intermediate Forms, Semi- or Quasi-Public Legal Rules, Enforceable by Private Means

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

- *Relative adequacy of existing practices.* Are the salient problems with practice objectively determinable (that is, no tag-along rights, too many nonvoting shares, application of substandard accounting rules, uncertain rules for protecting minority shareholders in delistings, and so forth) or more subtle (poor-quality audits, lackluster boards, conflicted managers, boards, regulators, and investors)?

- *Number, size, and industry of public issuers.* Is there a clubby atmosphere among controlling shareholders and corporate executives or 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, pension, 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 rule making (and dispute resolution), like the Novo Mercado, probably works best when (a) there is general agreement on the set of objectively determinable deficiencies that exist with the legal framework or practices and (b) 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 or voluntary codes or rating criteria) are likely to have the most immediate impact on the IPO market, as they provide investors with a common negotiating position. One prominent Latin American policymaker once told a group of foreign institutional investors after a meeting with local chief executive officers, "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 there is a relatively small number of issuers, such 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 determine how useful the recent experiments in public and private law in emerging markets are for 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, Thailand, Colombia, and elsewhere lead us to suspect that there is likely to be space in many emerging markets for intermediate forms of rule making: semi- or quasi-public legal rules enforceable by private means (for example, special listing segments, ratings and other types of benchmarking, and legal investment disclosure regimes).

Tentative Conclusions

In terms of mobilizing the forces of the capital markets effectively to raise standards of governance in corporations, the Latin American case studies are instructive. The initiatives differ among themselves, depending on factors like prevailing forms of corporate ownership and capital structure, and may not be directly transferable elsewhere in all cases. Nevertheless, they are instructive. The Latin Americans are proving adept at legal transplantation; they have the advantage of proximity and exposure to North American law, markets, and practices. Both Mexico and Quebec, which are French civil code jurisdictions, can fearlessly introduce Anglo-American concepts of trust law and make them work because they understand and have long experience working with the principles. Further, they want to make the transplants work (Pistor's voluntary adoption predictor of effectiveness); the integration of the North and South American capital markets is well advanced, and the international signaling imperative is at work.[63] And the Latin Americans are introducing governance mechanisms in multiple guises along the

[63] J. Coffee Jr., "The Coming Competition among Securities Markets: What Strategies Will Dominate?" www.Law.columbia.edu/law-economicstudies/papers/wp192.pdf (September 2001).

continuum of private and public legal rules in order to amplify the prospects of effectiveness.

Brazil's initiatives are particularly interesting because they are moving contractual governance mechanisms (private legal rules) into the listing rules (semi-public legal rules) and then backing them with corresponding legislative changes (ex ante public legal rules). Bovespa's Novo Mercado has elicited a good deal of attention elsewhere.[64] It may prove to be an ideal vehicle for maximizing the effectiveness of capital market forces on the governance of corporations. Time will tell.

[64] The Jakarta Stock Exchange, for example, and its capital markets regulator, BAPEPAM, for example.