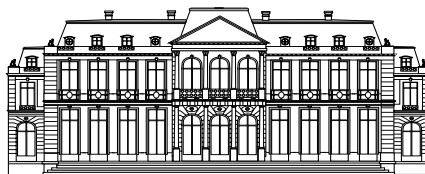


CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE

Seoul, 3-5 March 1999

Organisation for Economic Co-operation and Development



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**“CORPORATE GOVERNANCE IN ASIA: A
COMPARATIVE PERSPECTIVE”**

**Professor Bernard Black
Stanford Law School**

***Creating Strong Stock Markets by Protecting Outside
Shareholders***

Seoul, 3-5 March 1999

CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE
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**The Legal and Institutional Preconditions
for Strong Stock Markets:
The Nontriviality of Securities Law**

Bernard S. Black
Stanford Law School

draft September 1999

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Abstract

An important challenge for all economies, at which only a few have succeeded, is providing an environment in which minority shareholders have (i) good information about the value of a company's business, and (ii) confidence that a company's managers and controlling shareholders won't cheat them out of most or all of the value of their investment. A country whose laws and related institutions foster that knowledge and confidence has the potential to develop a vibrant stock market that can provide capital to growing firms. A country whose laws and related institutions fail on either count cannot develop a strong stock market, forcing firms to rely on internal financing or bank financing -- both of which have important shortcomings. This article explains why these two investor protection issues are critical, related, and hard to solve. It also discusses which of the needed laws and institutions can be borrowed from countries with strong securities markets and which much be home-grown.

Comments are welcome. Address them to:

Prof. Bernard S. Black
Stanford Law School
Stanford CA 94305
1-650-725-9845 voice
1-650-725-0684 fax
bblack@stanford.edu

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**The Legal and Institutional Preconditions for Strong Stock
Markets: The Nontriviality of Securities Law**

Table of Contents

I. Introduction	1
II. Information Asymmetry Barriers to Securities Offerings	4
A. Information Asymmetry and the Role of Reputational Intermediaries	4
B. The Institutions that are Needed to Control Information Asymmetry	10
C. Additional Useful Institutions	18
III. Protecting Minority Investors Against Inside Dealing	19
A. Inside Dealing as an Adverse Selection/Moral Hazard Problem	19
B. The Institutions that are Needed to Control Insider Self-Dealing	22
IV. Can Companies and Countries with Weak Institutions Piggyback on Other Countries' Institutions	9
V. Strong and Weak Securities Markets: A Separating Equilibrium?	40
VI. Different Types of Monitoring: Investor Protection and Firm Performance	41
VII. Conclusion: What Steps to Take First	43

I. Introduction

A strong public securities market, especially a public stock market, can facilitate economic growth by providing a way for growing companies to raise capital. Securities markets have several potential advantages over the principal alternatives -- bank financing and internal financing. First, countries with strong securities markets are less dependent on bank financing. Banks are an institutional form that is prone to credit crunches and other troubles, which can reverberate through the whole economy. Second, a public stock market lets companies rely more on equity and less on debt, which gives them greater financial flexibility in an economic downturn, and may reduce the downturn's severity. Third, a stock market lets companies rely more on external capital and less on internal capital, which helps companies grow rapidly, and gives companies that focus on a single core business an advantage over diffuse conglomerates. In the United States, conglomerates are seen as a failed experiment -- they are usually less efficient than more focused firms. Conglomerates remain strong in countries with weak stock markets, partly because the conglomerate form can provide the access to capital that a rapidly growing firm needs. The shortcomings of bank finance and the internal capital markets run by conglomerate groups were, in significant part, behind the recent finance-driven economic troubles in East Asia and elsewhere.

But creating strong public securities markets is hard. That securities markets exist at all is magical, in a way. Investors pay enormous amounts of money for completely intangible rights, whose value depends entirely on the quality of the information that the investors receive and on the honesty of other people, about whom the investors know almost nothing. Internationally, this magic is rare. It does not appear in unregulated markets. Even among developed countries, only a handful of countries have developed strong stock markets that permit growing companies to raise equity capital.

There is only limited prior work on the prerequisites for strong securities markets. Black & Kraakman (1996) argue that protecting minority investors against self-dealing by company insiders is essential, but focus on company law and do not consider other necessary laws and related institutions.¹ Black (1998) argues that controlling information asymmetry is essential for building strong stock markets.² La Porta, Lopez de Silanes, Shleifer & Vishny (1997, 1998a, 1998b, 1999) develop evidence that legal protection of minority shareholders correlates with the strength of a country's capital market, but do not address which legal rules are most important or consider related institutions.³ Modigliani & Perotti (1998) document an inverse relationship between measures of corruption and the strength of public securities

¹ Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 **Harvard Law Review** 1911-1981 (1996).

² Bernard Black, *Information Asymmetry, the Internet, and Securities Offerings*, 2 **Journal of Small and Emerging Business Law** 91-99 (1998), also available from the Social Science Research Network electronic library at <http://papers.ssrn.com/paper.taf?abstract_id=84489>.

³ Florencio Lopez de Silanes, Andrei Shleifer & Robert Vishny, *Legal Determinants of External Finance*, 52 **Journal of Finance** 1131-____ (1997); Rafael La Porta, Florencio Lopez de Silanes, Andrei Shleifer & Robert Vishny, *Law And Finance*, 106 **Journal of Political Economy** 1113-1155 (1998a); Florencio Lopez de Silanes, Andrei Shleifer & Robert Vishny, *Agency Problems and Dividend Policies Around the World* (working paper 1998b), available from the Social Science Research Network Electronic Library at <http://papers.ssrn.com/paper.taf?abstract_id=52871>; Rafael La Porta, Florencio Lopez de Silanes and Andrei Shleifer, *Corporate Ownership Around the World*, 54 **Journal of Finance** 471-517 (1999).

Seoul, 3-5 March 1999

markets.⁴ Coffee (1999) is the closest in spirit to this paper. He argues that securities law that protects minority investors is central to the value of publicly issued shares, but that in countries with weak laws, companies can often piggyback on the securities markets of developed countries by listing their shares on stock exchanges in those countries.⁵

This article explores which laws and related institutions are essential for strong securities markets. My goal is threefold: to explain the precursors for the development of strong markets in countries, like the United States and the United Kingdom, that already have these markets; to offer a guide to legal and institutional reforms that could strengthen securities markets in other countries; and to offer some cautionary words for developing countries about the complexity of the laws and related government and private institutions that are needed to support strong securities markets, and the difficulty of creating this institutional infrastructure.⁶

There are two essential prerequisites for strong securities markets. A country's laws and related institutions must give minority shareholders: (i) good information about the value of a company's business; and (ii) confidence that the company's insiders (its managers and controlling shareholders) won't cheat

⁴ Franco Modigliani & Enrico Perotti, *Security Versus Bank Finance: The Importance of a Proper Enforcement of Legal Rules* (working paper 1998), available from the Social Science Research Network Electronic Library at <http://papers.ssrn.com/paper.taf?abstract_id=157281>.

⁵ John Coffee, *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 **Northwestern University Law Review** 641-707 (1999).

⁶ The subtitle of this article, "The Nontriviality of Securities Law," is a play on an earlier article of mine, Bernard Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 **Northwestern University Law Review** 542-597 (1990), in which I argue that American corporate law is mostly and perhaps entirely trivial, in the sense that it doesn't significantly constrain any private contractual arrangements that a company's shareholders want to choose for themselves.

investors out of most of the value of their investment. If these two steps can be achieved, a country has the potential to develop a vibrant stock market that can provide capital to growing firms, though still no certainty of developing such a market. Conversely, a country whose laws and related institutions fail on either of these two counts cannot develop a strong stock market. This forces firms to rely on bank financing or internal financing.

Individual companies can partially escape the weakness of their home country's institutions by listing and selling their shares on a stock exchange in a country with strong institutions, and following that country's rules. But only partial escape is possible. Much still depends on the availability of local enforcement.

The connection between strong investor protection along these two dimensions and strong securities markets creates the potential for two separating equilibria to exist. In the first or "lemons" equilibrium, honest companies (except a few large companies that can develop their own reputations) don't issue shares to the public, because weak investor protection prevents them from realizing a fair price for their shares. This decreases the average quality of the shares that are issued, which further depresses prices and discourages honest issuers. In the second "strong markets" equilibrium, strong investor protection produces prices that make it attractive for honest companies to issue shares, which increases the average quality of the shares that are issued, which further increases share prices and encourages more honest issuers. This article can be seen as an attempt to develop minimum conditions for achieving the "strong markets" equilibrium.

The analysis developed in this article also suggests that the standard debate over the merits of bank-centered versus stock-market-centered capital markets is partly misplaced. The standard debate posits that bank-centered markets can achieve stronger monitoring of management, while stock-market-centered markets offer greater liquidity but weaker monitoring due to dispersed shareholdings, albeit partly counteracted by a market for corporate control. The perspective offered here is that a stock-market-centered capital market is possible only if a country *first* develops strong monitoring along the dimensions of information disclosure and control of insider self-dealing. Bank-centered capital markets may be stronger than stock-market-centered capital markets in ensuring that companies are not only *honestly* run, but also *well* run. But even if this is the case (this remains a disputed question), this would mean only that the two systems have different monitoring strengths, with neither clearly dominating the other along an overall monitoring dimension.

I will address the prerequisites for a strong securities market in the context in which they are most acute -- a public offering of common shares, often by a company that is selling shares to the public for the first time. Similar though less acute issues arise for issuance of debt securities.

Part II of this article explains why controlling information asymmetry is critical for developing strong public stock markets, and which laws and institutions are needed to do so. Part III explains why controlling insider self-dealing is equally critical, and the overlapping but somewhat different laws and institutions that are needed for this task. Part IV explores the extent to which companies can escape the weaknesses of their home country's laws and institutions by relying on foreign rules and institutions. Part V considers the possibility that securities markets may involve a separating equilibrium, in which a

country's market tends to gravitate toward either a "lemons" or a "strong market" equilibrium, depending on the quality of the local laws and institutions that support the securities market. Part VI discusses the implications of the analysis in this article for the conventional view that stock-market-centered capital markets produce weaker monitoring of management than bank-centered capital markets: they may, but only along some dimensions. Part VII concludes by discussing which steps a developing country should take first, with the long-term goal of establishing a strong securities market.

II. Information Asymmetry Barriers to Securities Offerings

A. Information Asymmetry and the Role of Reputational Intermediaries

A critical barrier that stands between issuers of common shares and public investors is asymmetric information. The value of a company's shares depends on the company's future prospects. The company's past performance is important as a (partial) guide to future prospects. The company's insiders know about both past performance and future prospects, but investors don't know this information and can't easily find out. The insiders have information; investors need information.

Delivering information to investors is easy; but delivering *credible* information is hard. Insiders have an incentive to exaggerate the issuer's past performance and future prospects, and investors can't directly verify the information that the issuer provides. This problem is especially serious for small companies and companies who are selling shares to the public for the first time. For these companies, investors can't rely on the company's prior reputation to signal the quality of the information that it provides.

In economic jargon, securities markets are a vivid example of a market for lemons.⁷ Indeed, securities markets are a far more vivid example than George Akerlof's original example of used cars. Used car buyers can visually observe the car, take it for a test drive, have a mechanic inspect the car, and ask their friends about their experiences with the same car model or manufacturer. By comparison, a company's shares, when it first goes public, are like a unique, unobservable car, on which investors can obtain only dry written information, that they can't directly verify. They have only the comfort of knowing that other, similarly (ill)informed investors have reached similar conclusions about value.

Investors don't know which companies are truthful and which aren't, so they discount the prices they will offer for the shares of all companies. This may ensure that investors receive a fair price, on average. But consider the plight of an "honest" company -- a term that I will use to mean a company whose insiders both report truthfully to investors and won't divert some or all of the company's income stream to themselves, apart from a market rate of compensation for management services. "Honesty" thus requires both truthful disclosure and nondiversion of value. I will focus in this part on disclosure, and discuss value diversion by insiders in Part III.

⁷ The obligatory citation here is to George Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 *Quarterly Journal of Economics* 488-499 (1970).

Seoul, 3-5 March 1999

Discounted share prices mean that an honest issuer can't receive fair value for its shares, and has an incentive to turn to other forms of financing. But discounted prices won't discourage dishonest issuers. Shares that aren't worth the paper they're printed on are, after all, quite cheap to produce. The prospect of receiving even a "discounted" price for worthless paper will attract some issuers.

This "adverse selection" by issuers, in which high-quality issuers leave the market because they can't obtain a fair price for their shares, while low-quality issuers remain, worsens the lemons problem faced by investors. Investors rationally react to the lower average quality of issuers by discounting still more the prices they will pay. This in turn drives even more high-quality issuers out of the market and exacerbates the adverse selection problem.

Some countries, including the United States, have partially solved this information asymmetry problem through a complex set of laws and private and public institutions that give investors reasonable assurance that the issuer is being (mostly) truthful. Among the most important institutions are reputational intermediaries, who vouch for the quality of particular securities. These intermediaries -- including accounting firms, investment banking firms, and law firms -- can credibly vouch for the quality of information because they are repeat players who will suffer reputational loss if they permit a company to exaggerate its prospects, that exceeds the intermediary's one-time gains from permitting the exaggeration.⁸ The backbone of these intermediaries is stiffened by the risk of legal liability if they endorse faulty disclosure, and government civil or criminal prosecution if they do so intentionally.

But even in the United States, "securities fraud" -- the effort to sell shares at an inflated price through false or misleading disclosure -- is an ongoing problem, especially among small issuers. Attempts by skilled con men to sell fraudulent securities are endemic partly because the United States' very success in creating an overall climate of honest disclosure leads investors to be (rationally) less vigilant in investigating claims by persuasive salesmen about particular companies. Investors' willingness to accept claims of past or future profits at something close to face value, in turn, creates fertile soil for fraud.

Most American investors still expect newly issued securities to be vouched for by reputational intermediaries. They expect financial statements to be audited, shares to be underwritten by a reputable investment banker, and the prospectus to be prepared by securities counsel. But this merely recreates the fraud problem one step removed. The United States' very success, in creating an environment in which most reputational intermediaries guard their reputations, creates an opportunity for new entrants to pretend to be reputational intermediaries. Merely calling oneself an investment banker will engender some degree of investor trust, because most investment bankers are honest and care about their reputations, and because investors (rationally) don't fully investigate the claims that investment bankers make about the quality of their reputations. The other key intermediaries -- accountants and securities lawyers -- can similarly trade on their profession's generally honest reputation (notwithstanding the occasional snide joke about whether that reputation is deserved).

⁸ On the pervasive role of reputational intermediaries in securities markets, see Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 *Virginia Law Review* 549-644 (1984), at 595-607.

To employ the standard terminology of welfare economics, investment banking (or accounting or securities lawyering) involves an externality -- any one participant can't fully capture the gains from its own investment in reputation. Some of the investment enhances the reputation of the entire profession, and is captured by others through greater investor trust in investment bankers as a class. That externality creates well-known problems. It reduces investment bankers' incentives to invest in reputation, since they can't capture all of the benefits of the investment. And new entrants can free-ride on reputational spillover from the established firms.

If one couples the ability to free ride on the reputations of other investment bankers with ease of entry, it will make sense for some entrepreneurs -- whom I will call "bogus investment bankers" -- to go into the investment banking business, intending never to develop their own reputations, but instead to profit by pretending to investors that their recommendation of a company's shares has value. In effect, bogus investment bankers steal some of the value of their competitors' reputations, while at the same time devaluing those reputations, because bad reputations spill over to the rest of the profession just as good ones do.

The result is ironic: Reputational intermediaries' principal role is to vouch for disclosure quality of disclosure and thereby reduce information asymmetry in the market for securities. But information asymmetry in the market for reputational intermediaries limits their ability to play this role.

One possible solution is second-tier reputational intermediaries, who can vouch for the quality of the first-tier intermediaries. Voluntary self-regulatory organizations play, in part, the role of a second-tier intermediary. A second solution involves legal rules that make the intermediaries liable to investors, and various forms of government intervention aimed at establishing minimum quality standards for the intermediaries -- licensing of reputational intermediaries; investigating cases where the intermediaries did not behave as they ought; revoking the license of a misbehaving intermediary; criminal prosecution if the intermediary misbehaves intentionally. The greater sanctions available through the legal system, plus the ability to collectivize the cost of enforcement (by spreading the cost of private enforcement among investors through a class action or derivative suit, and spreading the cost of public enforcement; through taxes), may explain why these strategies seem to dominate over creation of second-tier reputational intermediaries.

A mixed solution, sometimes adopted in securities markets as a supplement to official enforcement, involves *mandatory* self-regulatory organizations. In the U.S., for example, investment bankers must belong to a self-regulatory organization (the available organizations are the New York Stock Exchange and the National Association of Securities Dealers). A member evicted by one organization is unlikely to be accepted by the other. Thus, the organization's power to evict a member becomes the power to put the member out of business, not merely deprive it of the reputational enhancement that voluntary membership could bring.

The resulting system, in which multiple reputational intermediaries vouch for different aspects of a company's disclosure, while self-regulatory organizations, private plaintiffs, and the government police the reputational intermediaries, can work tolerably well. But it is scarcely simple. And it may require, for

continued success, some ongoing government effort (how much is an open question) to protect the reputational intermediaries against the depredations of bogus intermediaries who would otherwise profit from the unearned spillover of reputation to them, and perhaps bring the whole system crashing down.

The complexity of this response to the information asymmetry problem goes a long way toward explaining why many nations have not developed an acceptable solution to this problem. Their securities markets have instead fallen into what insurance companies call a "death spiral," in which information asymmetry and adverse selection combine to drive almost all honest issuers out of the market, and to drive share prices to zero.

In these countries, a few large companies may develop reputations sufficient to justify a public offering of shares at a price that, though below fair value, is still attractive compared to other financing options. But smaller companies have essentially no direct access to public investors' capital. They must obtain capital from intermediaries (usually banks), or the internal capital "market" of a conglomerate group, or else grow only at the rate permitted by reinvestment of past earnings.

For high-technology companies, information asymmetry is especially severe because these companies often have short histories, make highly specialized products, and participate in fast-moving industries that are hard for investors to understand. This makes it easier for insiders to exaggerate the industry's growth prospects, or the company's prospects within the industry. As a result, even countries with strong stock markets, such as the United States, have developed a specialized institution -- the venture capital fund -- that funds high-technology companies early in their life, and functions in significant part as a specialized reputational intermediary. Venture capital funds engage in detailed, costly investigation of companies that seek funding, and then implicitly vouch for these companies when they later seek to raise capital in the securities markets.⁹

Venture capitalist intermediation is expensive, but has thrived because, presumably, it adds value that exceeds its costs. One major reason is that venture capitalist intermediation reduces information asymmetry costs. A second is that intensive monitoring has value especially for early stage companies. Take the two together, and entrepreneurs prefer to pay the high price of venture capital funding, rather than sell stock to the public early in a company's existence.

⁹ For evidence on the role of venture capital funds as reputational intermediaries, see Alon Brav & Paul Gompers, *Myth or Reality? The Long-Run Underperformance of Initial Public Offerings: Evidence from Venture and Nonventure Capital-Backed Companies*, 52 *Journal of Finance* 1791-1821 (1997); Paul Gompers & Josh Lerner, *Conflict of Interest in the Issuance of Public Securities: Evidence from Venture Capital*, 42 *Journal of Law and Economics* 1-28 (1999).

Ronald Gilson and I argue in a recent article that to understand how venture capital funds operate, you have to understand the synergy between their visible role in providing financial capital and their less visible but equally important role in providing reputational capital and monitoring. For early stage, high-technology companies, the combination of these three services dominates the alternative that public securities markets offer of providing financial capital *without close monitoring*, or the alternative of monitoring and providing reputational capital *without investing*, which is a plausible institutional arrangement that we don't see.¹⁰

If developing a strong public securities market is hard, developing strong venture capital is harder still. Venture capital funds face a classic chicken and egg problem in getting started -- a venture capitalist can't get funding until he develops a reputation for making good investments, but can't develop a reputation without making investments. Once the venture capital industry exists, new funds can be started by people who leave existing funds where they have developed a track record. But the initial stages of industry development, where this path isn't feasible, are likely to be slow. Thus, we should expect -- and as we look around the world we find -- that strong venture capital is even rarer than a strong public stock market.

High-technology companies are not the only area where specialized reputational intermediaries have developed over time. For money managers who manage pension funds and other institutional assets, a cottage industry has arisen of consulting firms who verify the money managers' performance claims, and a related industry that develops performance indexes against which the performance of a money manager with a particular style or investment focus can be measured. For bonds and other fixed-income investments, bond-rating agencies such as Moody's and Standard & Poor's offer quality ratings for different issuers.

B. The Institutions that are Needed to Control Information Asymmetry

Successful securities markets have developed a number of institutions to counter information asymmetry, some of which were suggested above. Information disclosure centers on financial disclosure. I list below the institutions that I consider necessary. The list is judgmental, and is in an order that makes logical sense, *not* in order of estimated importance. Part IV combines this list and the related list of institutions to control insider self-dealing into a single table.

(1) *Extensive financial disclosure, including independent audits of public companies' financial statements.*

¹⁰ See Bernard Black & Ronald Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 *Journal of Financial Economics* 243-277 (1998).

It is hard to imagine how a stock market could thrive if listed companies didn't provide investors with audited financial statements. The risk of financial statements that are either outright fraudulent or seriously misleading is too great. The ease with which fraudulent securities can be created means that securities markets attract con artists, who are skilled in spinning plausible stories about why a particular company has a marvelous future. Audited financial statements provide a critical reality check on these stories.

Whether the audited statements must be required by law, or will emerge through a stock exchange rule or simply through common practice, is an oft-debated question that I need not address here. But the arguments in favor of mandating disclosure surely become stronger, the weaker a country's securities markets and the culture of disclosure that supports those markets.¹¹

(2) Accounting rules that address investors' need for reliable information.

¹¹ For pieces of the mandatory disclosure debate, see Anat R. Admati & Paul Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities* (working paper 1998), available from the Social Science Research Network Electronic Library at <http://papers.ssrn.com/paper.taf?abstract_id=103968>; Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 **University of Chicago Law Review** 1047-1112 (1995); **Frank Easterbrook & Daniel Fischel, The Economic Structure of Corporate Law** ch. 11 (Harvard Univ. Press 1991); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 **Virginia Law Review** 717-753 (1984).

Good accounting rules should provide information in a form that is useful to investors. They should facilitate evaluating a company's past performance, and comparing it with similar companies, in the same country and internationally, and limit managers' flexibility to pick and choose among alternate accounting practices in order to make their own firm appear more profitable. Overly flexible rules can reduce comparability, increase opportunities for fraud, and increase overall information asymmetry between companies and investors.¹² At the same time, the accounting rules must strike a sensible balance among investors' desire for information, the cost of providing the information, and companies' concern that giving detailed information to investors means giving the information to competitors as well.

(3) *A rule-writing institution with the competence to write good accounting rules and an incentive to keep the rules up to date.*

In many countries, accounting rules are written by the Finance Ministry, which tends to write the rules with a view to providing the information needed to collect taxes, rather than the information needed to attract investment or manage the business. Thus, the rule-writing task is ideally placed elsewhere -- in a securities commission or perhaps, as in the United States and Great Britain, in a quasi-public "self-regulatory" organization run by accountants and supervised by the securities commission or another regulatory agency.¹³

Writing good accounting rules requires close knowledge of how companies operate, appreciation for changes in corporate practices, which are often intended to take advantage of loopholes in the existing rules so as to portray a firm's performance as better than it really is, and the ability and incentive to write new rules and interpret old ones with reasonable dispatch. Other things equal, this may offer some reason to vest rule writing in a quasi-public organization run by accountants, rather than a government agency.¹⁴

¹² See generally Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What you Measure*, 96 *Columbia Law Review* 1335-1362 (1996).

¹³ For an overview of U.S. and British practice in setting accounting rules, see **Brian Cheffins, Company Law; Theory, Structure, and Operation** 372-73, 376-77 (Oxford Univ. Press 1997).

¹⁴ See Cheffins (1997), *supra* note 11, at 378-420, for discussion of the advantages and disadvantages of self-regulation, both

(4) A sophisticated accounting profession with the skill and experience to catch at least some instances of false or misleading disclosure.

At the end of the day, audit requirements and accounting rules are no better than the accountants who conduct the audits and apply and interpret the rules. Accounting is part science (following established rules), but in important part remains a skilled art. With the twist that the artist's task is to paint an accurate picture, while the subject is trying to persuade the artist that a more flattering portrait is a truer one, and a minority of subjects are crooks, prepared to do whatever they can to mislead the artist and thus the investors who are the ultimate viewers of the portrait. As a further twist, the subject is paying the artist's fee, so that the artist faces the omnipresent threat of being replaced if the portrait is less flattering than the subject wants.

Professionalism -- both to see the truth that the subject has tried to conceal, and to resist the subject's pressure for an overly flattering portrait -- is essential if the resulting portrait is to resemble reality and be comparable to other portraits painted by other artists.

(5) Securities or other laws that impose on accountants enough risk of liability to investors if the accountants have endorsed false or misleading financial statements so that the accountants will resist their clients' pressure for more favorable disclosure.

Accountants are reputational intermediaries. They sell their services in preparing and reviewing financial statements, but in doing so, they also rent out their reputations for conducting a careful audit that can catch some fraud, discourage most attempts at fraud, and for painting a tolerably accurate picture of a company's financial performance.

Experience teaches that at least some legal liability is an important buttress for the accounting firm's concern for reputation. Liability can help to persuade the firm to establish strong internal procedures to ensure that the audits it conducts, and the financial statements that it prepares or reviews, meet minimum quality standards. At the same time, liability risk provides a compelling argument that the accounting firm can offer to a client that is pushing hard for more favorable treatment than the accounting firm wants to offer.

The needed liability risk doesn't have to be great. I make no claim that aggressive, American style class action litigation against accounting firms is necessary or even desirable. Perhaps a few lawsuits per decade, a couple of which result in a significant payout (in settlement or after a verdict), are enough. But if there is no liability risk, the temptation for even the largest accounting firms to squander reputation to gain a client will always be present and will sometimes be accepted.

for accounting rules and other aspects of company and securities regulation, drawing largely on British experience.

Creating meaningful liability risk requires not just formal liability rules, but also procedural rules that make it feasible for small shareholders to incur the expense of a lawsuit. One may not need contingent fees, but one surely needs a class action procedure or another way to combine a number of individually small claims.

(6) A sophisticated investment banking profession that will investigate the issuers of securities that the investment bank underwrites because the investment banker's reputation depends on not selling fraudulent or overpriced securities to investors.

Investment bankers are a second key reputational intermediary. In developed securities markets, they have learned to walk a fine line between being selling an offering and not overselling it. An important part of their role involves conducting a "due diligence" investigation of the issuer, to satisfy themselves that the issuer's future prospects are reasonably stated in the offering documents and oral sales presentations, that the issuer's managers appear to be honest, and that investors understand the major risks of the investment. For example, it is standard practice for an investment bank to conduct a background check on an issuer's insiders, and to walk away if the insiders have an unsavory past.

Investment bankers' reputation is policed in a number of ways. First, securities purchasers will remember if an investment bank sold them a number of bad investments, and avoid (or pay less for) its future offerings. Second, just in case securities purchasers haven't noticed, each investment bank will keep track of the "aftermarket" performance of its own and its competitors' offerings, happily disclose to a prospective client its competitors' weak performance, and worry greatly if the aftermarket performance of its own offerings suffers, because this is a recipe for trouble in the medium to long term.

Third, in the rare cases when a major underwriter unwittingly sells shares for a fraudulent company, which then collapse in price when the fraud is discovered, this is considered a major embarrassment, not soon forgotten by investors (or by the bank's competitors, who will bring it up at every convenient opportunity).

(7) Securities or other laws that impose on investment bankers enough risk of liability to investors if the investment bankers underwrite securities that are sold with false or misleading disclosure, so that the bankers will resist their clients' entreaties for more favorable disclosure.

Experience teaches that at least some legal liability is an important buttress for an investment banker's concern for reputation. Liability can help to persuade the firm to establish strong internal procedures to ensure that the companies whose shares it underwrites meet minimum quality standards. At the same time, liability risk provides a compelling argument that the investment banker can offer to a client that is pushing hard for more favorable disclosure, or a higher offering price, than the investment banker wants to offer.

As for accountants, I make no claim that frequent litigation against investment bankers is necessary. A few lawsuits per decade, a couple of which result in a significant payout (in settlement or after a verdict), could well be enough. But if there is no liability risk, the temptation for firms to squander reputation to gain a client will always be present and will sometimes be accepted.

(8) Sophisticated securities lawyers who can ensure that a company's offering documents comply with the disclosure requirements.

Securities lawyers are a third major reputational intermediary -- albeit less visible to investors than accountants or investment bankers. In developed securities markets, they have learned to walk a fine line between being accepting the favorable statements that the issuer wants to make, and cautioning the issuer and the investment banker about the need for cautionary disclosure.

Because securities lawyers are less visible to investors than accountants or investment bankers, I have not listed whether they face a significant risk of liability as a *necessary* condition for developing a strong securities market. But some liability risk for lawyers is surely a *useful* institution.

(9) A stock exchange with meaningful listing standards, and the willingness to enforce them by fining or delisting companies that violated disclosure rules.

Stock exchanges are a fourth important reputational intermediary. They establish and enforce listing standards, including disclosure requirements, because they understand that investors use the listing as a proxy for company quality, and that false disclosure by a few companies will taint all companies.

(10) Securities or other laws that impose severe sanctions on insiders for false or misleading disclosure, including criminal sanctions where appropriate.

Sophisticated accountants, investment bankers, and lawyers are a second line of defense against securities fraud. The primary defense, though, is direct sanctions against the insiders who attempt to carry out the fraud.

Some of the time, perhaps most of the time, insiders will want to preserve a company's ability to issue shares in the future, and will therefore want to maintain the company's reputation for honest disclosure. But insiders' concern for future reputation isn't enough to ensure honest behavior. Some of the time, the company will be in a financial bind, where if it doesn't raise funds this time, there won't be a next time. In the language of game theory, the insiders are in the final period of a repeated game, where they have an incentive to cheat, since there won't be a next round in which the cheating can be punished.¹⁵ Other times, the insiders' tenure in the company may be at risk, even if the company's solvency is secure. Here, the insiders face a final period, even if the company doesn't. Moreover, some con artists, attracted by the ease of creating valueless companies and selling valueless shares, will happily take whatever money they can raise this time, and then hope to sell another company's shares the next time.

The incentives of insiders to puff their company help to explain the universal use in public offerings of reputational intermediaries, who investigate and vouch for the disclosure that the insiders prepare. But just as some liability is important to ensure that reputational intermediaries behave as they are supposed to, some liability is important to ensure that insiders disclose honestly in the first place.

¹⁵ See generally **Robert Axelrod, The Evolution of Cooperation** (1984).

Financial liability of insiders to investors is not a sufficient deterrent, however. Insiders often have little wealth outside their firm, or can hide much of their wealth out of investors' reach. That makes criminal sanctions a critical supplement to the insiders' financial liability to investors.

(11) A securities regulator (and, for criminal cases, a prosecutor) that is (i) honest; and (ii) has the staff, skill, and budget to pursue complex securities cases involving false or misleading disclosure.

Honest regulators and prosecutors are obviously essential. They tend to be taken for granted in developed countries, but are often partly or wholly absent in developing countries.

With regard to the need for a specialized regulator and specialized prosecutors, some securities cases involve outright fraud -- the company has reported sales or inventory that didn't exist. Those cases aren't hard for a prosecutor to bring. But they aren't especially sexy either, and could get little attention from a prosecutor with limited resources, who would rather pursue muggers and murderers. Moreover, many securities fraud cases aren't so clearcut. The insiders twisted the truth, but in a way that takes careful digging through the company's records to uncover, and skill to present in convincing fashion to a court. Moreover, the defendants often have enough money to mount a vigorous defense. Experience teaches that even in developed countries, few prosecutors have the skill or discipline to bring securities fraud cases. Specialization is needed.

(12) A judicial system that is (i) honest; (ii) sophisticated enough to handle complex securities cases; (iii) can intervene quickly when needed to prevent asset stripping; and (iv) can produce decisions without intolerable time frame (and with appropriate adjustments for the time value of money).

An honest judiciary is a must for any investor remedies to be meaningful. As with honest prosecutors, this element of a disclosure system can be taken for granted in developed countries, yet is often partly or wholly absent in developing countries. With regard to sophistication, the same subtle securities fraud cases that call for specialized prosecutors require sophisticated judges. A specialized court is ideal. A general court that sees a hefty percentage of securities and other complex commercial cases, perhaps because of its location in the country's financial center, is an acceptable substitute.

Speed is important too. When insiders commit fraud, some of it can sometimes be retrieved if the prosecutors move fast to freeze the insiders' assets pending the final outcome of a case that the prosecutors plan to bring. Otherwise, it is as good as gone -- any con artist smart enough to run a good con is smart enough to move his assets beyond the prosecutor's reach if given a warning that they may be seized, or lost in a court action. Beyond, that, while courts nowhere move quickly, differences in how fast they do move affect the salience of investor remedies. Moreover, a surprising number of countries award no or inadequate interest on judgments, which both undercuts the official sanctions and gives an incentive for the defendants to delay.

(13) Rules ensuring market "transparency": the time, quantity and price of trades in public securities must be promptly disclosed to investors.

One key source of information about value that investors rely on is the prices paid by other investors for the same securities. Investors may still make mistakes about value, but at least they know that they are not alone in their opinions. Transparency is a collective good that must be established by regulation. Large investors would prefer to hide their own transactions, to reduce the impact on price that their trades will have. Sometimes a stock exchange will have enough power to force all trades to be reported to it; more commonly, government intervention to mandate prompt reporting and ensure that all trades are reported in a single consolidated source.

(14) Rules banning manipulation of trading prices.

Transparency of market prices raises its own dangers. Especially in "thin" markets, insiders can manipulate trading prices to create the appearance that the shares are highly valued by outside investors, while dumping their own shares on the market. The principal response to this risk is rules against manipulating trading prices. These rules then need to be enforced. This requires a specialized regulator, because manipulation is notoriously hard to prove.

(15) An active financial press that can uncover and publicize instances of misleading disclosure, and criticize not only the company, but (when appropriate) the investment bankers, accountants, and lawyers as well.

Markets for reputation can work only if there is a mechanism for distributing information about the performance of both companies and intermediaries. Disclosure rules for companies help, as does reputational intermediaries' incentive to advertise their successes. But intermediaries can hardly be expected to publicize their failures. Their competitors may do so, but their reports may be discounted because they come from a biased source. An active financial press is an important source of reporting of disclosure failures.

A country's libel law is important here. The financial press can be chilled by libel laws that make it easy for deep-pocketed companies or intermediaries to sue anyone who is bold enough to criticize them. The chill is especially severe if the courts' honesty is suspect.

(16) A culture of disclosure that develops over time, among accountants, investment bankers, lawyers, and company managers, that concealing bad news is a recipe for trouble.

In countries with strong securities markets, the sanctions against misbehavior are collectively strong enough so that they reinforce a culture of compliance, in which a bit of puffing is acceptable, but outright lying is not. There are actions that no honest accountant, investment banker, or securities lawyer will be involved in. Moreover, very few managers will attempt clearly illegal actions, because they too grew up in a culture where disclosure is the norm, and where others are occasionally disgraced, or even sent to jail, for falsifying financial statements and the like.

Which came first – laws requiring disclosure, or a culture that supported disclosure, reinforced the laws, and made them politically feasible – is an unanswerable question. Most likely, the two developed together over time, and were mutually reinforcing.

C. Additional Useful Institutions

The list of institutions in Section B reflects my best judgment about which rules and institutions are the most important. It is by no means a complete list of the *useful* rules and institutions. For example, I argue above that it is important for reputational intermediaries, including accountants and investment bankers, to face a meaningful risk of liability to investors. It would also be useful for these intermediaries to be subject to a regulatory licensing scheme and risk regulatory sanctions, including fines, suspension and disbarment, for misbehaving individuals and, where appropriate, their firms. Those regulatory sanctions aren't listed above because I believe that, especially in less developed economies, private enforcement, through liability to investors, is likely to be a more effective tool for enforcing good behavior by reputational intermediaries than public enforcement through regulatory sanctions. Even in countries with strong regulators, regulatory sanctions are imposed fairly seldom and primarily in egregious cases; they will surely be an even weaker constraint in emerging economies, which are likely to have fewer regulatory resources, and better uses for those resources (such as pursuing insiders who have committed fraud, rather than sanctioning intermediaries who have merely failed to catch the fraud).¹⁶

Conversely, I argue above that official enforcement of the rules against fraud is essential for insiders. Financial liability of insiders to investors is also useful, but isn't sufficient because in too many of the most egregious cases, the insiders have no wealth, or can hide their assets beyond the reach of private plaintiffs.

¹⁶ For more general discussion of the reasons to believe that rules that can be privately enforced are likely to be more effective than rules that require public enforcement, see Black & Kraakman (1996), *supra* note 1.

Seoul, 3-5 March 1999

Mutual funds are another useful, complementary institution. They can collect money from individual investors, and provide them with both diversification and some insulation against inflated claims by con artists (who might fool novices, but will have a harder time fooling experts). In my judgment, a healthy mutual fund industry is more a result than a cause of a strong securities market, that itself relies on related institutions, including a law on investment funds that safeguards the mutual fund's assets against self-dealing transactions between the fund and the fund manager. Also, in a tolerably efficient market, small investors can freeride on the pricing judgments of professionals without the need to invest through an investment fund.¹⁷

The length of this list suggests the difficult task facing a country that wants to develop a strong stock market. Formal disclosure rules are important, but are not enough. The harder task is enforcing the rules -- both direct public enforcement and indirect enforcement through private institutions, especially reputational intermediaries like accountants, investment banking firms, securities lawyers, and stock exchanges.

III. Protecting Minority Investors Against Inside Dealing

A. Inside Dealing as an Adverse Selection/Moral Hazard Problem

The second major obstacle to a strong public stock market is the potential for insiders to appropriate most of the value of the company for themselves -- for 50% of the shares (less if the remainder are diffusely held) to convey 80% or 90% of the company's value. In some countries, where rules against insider dealing with a company are weak or routinely ignored, 50% ownership can convey essentially 100% of the company's value.

Insider self-dealing can occur in many variants and guises. But a useful division is between:

direct self-dealing, where a company that the insiders control, but only partly own, engages in transactions, not on arms-length terms, that enrich the insiders themselves, their relatives or friend, or a second company that they own a larger percentage of; and

indirect self-dealing, where insiders use information about the company that only they know to trade in public securities markets with less-informed investors (often called *insider trading*).

¹⁷ John C. Coffee, Jr., *The Lessons from Securities Market Failure: Privatization, Minority Protection and Investor Confidence* (working paper 1999), available from the Social Science Research Network electronic library at <http://papers.ssrn.com/paper.taf?abstract_id=_____>, argues that common law (as opposed to civil law) courts are an important components of investor protection, because they have greater latitude to develop and apply vague fiduciary principles to the many guises in which self-dealing can occur.

Of these, direct self-dealing is far and away the more important problem. First, it's far more profitable for the insiders. Direct self-dealing can turn 40% ownership (say) of shares into 100% ownership of profits, with little or no additional investment of capital. In contrast, insider trading takes capital and can't achieve anywhere near that level of profits. For one thing, insider trading depends on a liquid stock market, which the countries that haven't controlled direct self-dealing won't have. Without liquidity, you can't trade much, and without trading, you can't profit. For another, a long-term buy-and-hold investor can't be directly harmed by insider trading. You can only be on the losing side of a trade with an insider if you're trading.

But more critically, if direct self-dealing is hard to control, insider trading in anonymous securities markets is even harder to control. A telling statistics: The New York Stock Exchange alone spends \$_00 million annually on market surveillance, mostly aimed at controlling insider trading. This compares to the U.S. Securities and Exchange Commission (SEC)'s annual budget of \$___ million, for everything the SEC does.¹⁸

Moreover, without the institutions that are needed to control direct insider self-dealing, there is little hope of controlling insider trading. But the converse isn't true. A country could do fairly well at controlling direct self-dealing, without making the major additional investment needed to limit insider trading to tolerable levels.

The potential for insider self-dealing, whether direct or indirect, creates a lemons or adverse selection problem, which has the same structure as the adverse selection problem created by asymmetric information. Investors don't know which insiders are honest, and which will appropriate most of the company's value, so they discount the prices they will offer for the shares of all companies. This creates a dilemma for "honest" insiders who will not divert some or all of the company's income stream to themselves.

Discounted share prices mean that a company with honest insiders can't receive fair value for its shares, and has an incentive to turn to other forms of financing. But discounted prices won't discourage dishonest insiders. The prospect of receiving even a "discounted" price for worthless paper will be attractive to some insiders.

This adverse selection by issuers, in which high-quality issuers leave the market because they can't obtain a fair price for their shares, while low-quality issuers remain, worsens the lemons problem faced by investors. Investors rationally react to the lower average quality of issuers by discounting still more the prices they will pay. This drives even more high-quality issuers away from the market and exacerbates the adverse selection problem. As with asymmetric information, failure to control insider self-dealing can result in a "death spiral," in which insider self-dealing and adverse selection combine to drive almost all

¹⁸ [cites to come for NYSE surveillance spending and SEC annual budget].

honest issuers out of the market, and drive share prices to zero, save perhaps for a few large companies that can develop reputations sufficient to justify a public offering of shares.

In important respects, the problem of insider self-dealing is harder to solve than the problem of information asymmetry. First, honest disclosure of information during a public offering of shares can't be undone once the offering is completed. In contrast, once a company has sold shares, the company's insiders can always renege on a promise not to self-deal. Indeed, insiders have an incentive to renege -- to capture more of the company's value for themselves. That incentive is only imperfectly policed by the desire to maintain the company's reputation to facilitate a future offering of shares. Again, insurance terminology is helpful -- the incentive to renege is known as moral hazard. Unless controlled, it can be sufficient by itself to cause a public stock market to collapse.

Second, false or misleading disclosure in a public offering often occurs in a formal disclosure document, and thus leaves a paper trail. If subsequent events reveal the business problems that the company tried to conceal, the deficiencies in the original disclosure will often be obvious enough to make it straightforward for regulators or investors to seek sanctions or damages against the offending insiders and, if appropriate, their accountants, bankers, and lawyers. In contrast, insider self-dealing is often hidden. It must be uncovered before it can be policed.

Third, once a company has issued shares at a discounted price, in a market characterized by information asymmetry, insider self-dealing, and resulting adverse selection and moral hazard, the insiders may feel *entitled* to appropriate most of the company's value for themselves. They will fiercely resist any change in legal rules that limits this opportunity. An example call illustrate why insiders can feel this way.¹⁹

Assume that Company A has a value of \$100, and 50 outstanding shares, all held by insiders. The shares are worth \$2 each. But outside investors may be willing to pay only 50¢ per share for additional shares, both because the outside investors don't know the company's true value and because they expect insiders to appropriate most of whatever value exists. Suppose now that Company A issues 50 additional shares at this price, for total proceeds of \$25. Company A now has 100 shares outstanding, with 50 shares held by insiders and 50 shares held by outside investors, and total value of \$125.

If the insiders behave honestly and keep only 50% of the company's value, they will have cheated themselves. Their shares will be worth only \$62.50, while the outside investors' shares will be worth \$62.50 -- far more than the outside investors paid. The insiders' rational response is to self-deal by enough to ensure that they capture at least 80% of the firm's value -- \$100 out of the total value of \$125. They will not feel that they have cheated anyone by doing so -- they will feel instead that they have taken only their

¹⁹ This example is adapted from Coffee (1998), *supra* note 2.

proper share of the company's value. They will fight against legal and institutional reforms that might prevent them from taking what they see as their fair share of the company's value.

Those reforms will help new issuers obtain a higher price for their shares, but can harm the politically powerful insiders of already public companies. But in fighting against reforms, insiders of already public companies also reinforce a system in which minority shares have little value, and which won't prevent them from taking more than 80% of the company's value, if they so choose -- and some insiders will so choose.

B. The Institutions that are Needed to Control Insider Self-Dealing

Just as successful securities markets have developed institutions to counter information asymmetry, they have developed institutions to counter insider self-dealing. In some cases, these are the same institutions that control information asymmetry; in some cases, they are different institutions. The necessary institutions are listed below. The list is judgmental, and is in an order that makes logical sense, not in order of the estimated importance of different institutions. Part IV combines this list and the related list of institutions to control information asymmetry into a single table.

(1) Securities or other laws that require extensive disclosure of self-dealing transactions.

Insiders won't voluntarily announce to the world that they are engaged in self-dealing. Strong disclosure rules are needed, because if self-dealing transactions can be hidden, none of the other protections will be very effective.

(2) Requirements that a company's accountants review any self-dealing transactions and report on whether they were accurately disclosed.

Insiders have a powerful incentive to hide self-dealing despite formal disclosure obligations. Just as reputational intermediaries are needed to police companies' disclosure of financial information, they are needed to police disclosure by companies and insiders of self-dealing transactions. Unlike the situation when a company issues shares to investors, there is no discrete transaction, for which investors can insist in intervention by reputational intermediaries. If this intervention is desired, it must be mandated. Accountants are the obvious intermediary that can play this role.

If accountants play this role, then we will also need:

(3) A sophisticated accounting profession with the skill and experience to catch at least some nondisclosed self-dealing transactions, and insist on proper disclosure.

For an insider who is determined to self-deal, having an accountant looking over your shoulder is an obstacle that can often be overcome by suitably disguising the transaction, or your interest in the transaction, by running one or both through multiple intermediaries. For review by accountants to be effective, they must be sophisticated enough to catch at least the less subtle subterfuges, and thus raise the transaction costs of self-dealing.

Expecting the accountants to catch every instance of self-dealing isn't realistic. It would cost too much to investigate every transaction. But that only reinforces the importance of an accounting profession that knows which closets the skeletons are most likely to be hidden in, so the accountants can make productive use of limited resources.

If accountants act as reputational intermediaries, we will also need:

(4) Securities or other laws that impose on accountants enough risk of liability to investors if the accountants have endorsed nondisclosure, or false or misleading disclosure of self-dealing transactions, so that the accountants will resist their clients' entreaties to let them hide self-dealing transactions.

The reasoning behind the need for some liability risk is the same as for financial disclosure in general. The accountants are paid by the company, and will inevitably face pressure to overlook suspicious closets, or to accept a suspicious transaction at face value. Professionalism is one bulwark against stopping an investigation too early, but some risk of liability to investors is an important bulwark for professionalism.

(5) Company law or securities law that establishes procedural protections for self-dealing transactions, such as approval after full disclosure by independent directors, noninterested shareholders, or both.

Disclosure alone will deter some self-dealing. But a lot of self-dealing can still take place if the underlying transactions are lawful.

In a country such as the United States, with a well-developed culture of independence for outside directors, and skilled courts that can ferret out self-dealing when a shareholder sues *ex post*, it may be sufficient to vest approval power solely in the independent directors. But often, the nominally independent directors won't be all that independent in fact, especially for a company with a controlling shareholder, where the directors serve at the controlling shareholder's pleasure. Thus, it will often be important to place approval power, especially for larger transactions, in the hands of noninterested shareholders.²⁰

(6) Ownership disclosure rules that ensure that outside investors know who the insiders are, and that interested shareholders in fact cannot vote to approve a self-dealing transaction that requires approval by noninterested shareholders.

If noninterested shareholders are given decisionmaking power over self-dealing transactions, insiders will have an incentive to disguise their share ownership, in order to pretend to be noninterested. Disclosure rules are needed to prevent this.

More generally, as long as insider self-dealing is a significant risk, it will be important for outside investors to know who the insiders are. This will both help the outside investors to determine how much

²⁰ For discussion of rules to control insider dealing in a transition economy, and the choice between *ex ante* and *ex post* controls, see Black & Kraakman (1996), *supra* note 1, at 1932-34, 1958-60.

to trust the insiders this time, and give the insiders an incentive to develop reputations for not abusing their power.

(7) Strong sanctions against insiders for violating the disclosure or procedural rules governing self-dealing transactions, or for engaging in insider trading, including criminal sanctions where appropriate.

Oversight by reputational intermediaries, or requirements that a transaction, *if* disclosed, must be approved by independent decisionmakers, are important devices to enhance detection of attempted theft (for that is what insider self-dealing must be understood as), and reduce the frequency of the attempts. But they are no substitute for direct rules against theft, and meaningful sanctions against the thieves that are caught violating the rules.

Return of the ill-gotten gains is an insufficient remedy as long as the probability of detection is less than one. Damages equal to a multiple of the insider's gains are possible, but limited in effectiveness given the combination of limited insider wealth and the insiders' ability to hide, or remove from the jurisdiction, much of that wealth. Thus, criminal sanctions are a necessary supplement to civil damages.

(8) A securities regulator (and, for criminal cases, a prosecutor) that is (i) honest; and (ii) has the staff, skill, and budget to untangle complex self-dealing transactions.

As for financial disclosure, honesty and specialization are essential. In many countries, neither can be taken for granted. Insiders will often use transactional complexity and intermediaries to hide their interest in a transaction, and anonymous offshore accounts to hide insider trading. Proving a direct self-dealing case, or an insider trading case, often requires developing a chain of circumstantial evidence that will befuddle an ordinary prosecutor, or at least lead him to seek out easier cases.

(9) A judicial system that is (i) honest; and (ii) sophisticated enough to understand complex self-dealing transactions involving multiple intermediaries.

Honesty and sophistication are again basic, and often absent. Because insiders are dealing with themselves, or (for insider trading) with an anonymous market, they can often arrange a self-dealing transaction without a telltale paper trail.

(10) Company or other law that (i) requirements public companies to have a minimum number of independent directors; and (ii) imposes on independent directors enough risk of liability for approving self-dealing transactions that are grossly unfair to the company, so that they will resist pressure from insiders to approve these transactions.

I suggested above that approval by nominally independent directors can be an insufficient safeguard against self-dealing transactions, because the directors' independence will often be in doubt. But it remains an important safeguard, and the directors' potential liability for not behaving independently is a central support for whatever value this constraint can have.

The independent directors must be given the benefit of the doubt, or else truly independent directors will hesitate to serve for fear of financial liability. But if the insider dealing is egregious enough, the need for liability outweighs the potential chill on directors' willingness to serve.

(11) Sophisticated securities lawyers who can ensure that a company's satisfies the disclosure requirements and procedural protections governing self-dealing transactions.

A disclosure document for a self-dealing transaction, developed to obtain shareholder approval for the transaction, or an annual disclosure document that lists self-dealing transactions during the past year, will commonly be prepared by securities counsel. An important safeguard of accuracy is counsel's willingness to insist on full disclosure, to conduct enough due diligence to satisfy themselves that the disclosure is accurate, and to warn their clients about the risks of partial disclosure.

(12) An active financial press that can uncover and publicize instances of insider dealing.

Insiders will be more reluctant to engage in self-dealing, and independent directors, accountants, and securities lawyers, will be more vigorous in policing it, if a country has a financial press that is ready and eager to publicize misdeeds. As with the press's role in improving financial disclosure, a country's libel law is important, to ensure that press reporting is not unduly chilled by fear of a libel suit from an insider, who can finance the suit largely with someone else's (the company's) money.

(13) A culture of compliance that develops over time, among accountants, lawyers, and company managers, that concealing self-dealing transactions, approving a transaction that is seriously unfair to the company, ignoring the procedural protections for these transactions, or trading on inside information is a recipe for trouble.

In countries with strong securities markets, the sanctions against insider self-dealing, in both its direct and indirect variants, are collectively strong enough so that they reinforce a norm against such transactions. The culture further reduces the frequency of the transactions, and improves the quality of those that occur. The transactions that occur still may not be entirely fair to the company, but they are less likely to be grossly unfair.

To take one (of many) recent examples of Russian self-dealing, it would simply never occur to the managers of an American oil company to propose that the company sell its oil to supposedly unaffiliated offshore companies, that no one has ever heard of, for \$1.30 per barrel, when the market price is \$13 per barrel.²¹ The managers wouldn't propose this, the independent directors wouldn't approve it, and if it somehow occurred anyway, the accountants would qualify their report on the company's financial statements, the press would report the scandal, and hanging over everyone would be the threat of both civil and (for the managers) criminal liability.

²¹ See Bernard Black, Reinier Kraakman & Anna Tarassova, *What Went Wrong with Russian Privatization and Corporate Governance* (Stanford Law School, Olin Program in Law and Economics working paper no. 178, 1999), available from the Social Science Research Network electronic library at <http://papers.ssrn.com/paper.taf?abstract_id=181348>.

Which came first – laws controlling self-dealing, or a culture that frowns on them, reinforces the laws, and makes them politically feasible – is an unanswerable question. As for the disclosure norms, the two likely developed together and were mutually reinforcing.

Thus far, the list of necessary institutions has focused on the institutions needed to control self-dealing. I list next the additional institutions that are needed specifically to control insider trading.

(14) Securities or other laws that prohibit insider trading, suitably defined.

To be effective, a ban on insider trading must include a ban on tipping others, as well as on trading yourself.

(15) A good overall financial disclosure regime

The better the overall financial disclosure regime is, the harder it will be to hide gross direct self-dealing. Moreover, the better the information that is provided to the public, the smaller the profit opportunity from insider trading.

(16) A stock exchange with meaningful listing standards, the willingness to enforce them by fining or delisting companies that violate the rules governing self-dealing transactions, and the financial resources and skill to run a surveillance operation that can catch at least some insider trading.

For direct self-dealing, stock exchange enforcement, through delisting (or the threat of delisting), is an important supplement to official enforcement. For insider trading, the stock exchange is the institution that is best able to monitor its own trading, looking for unusual trading patterns that suggest insider trading.

As for information asymmetry, this list is a judgmental effort to assess the most important institutions, rather than an exhaustive list of *useful* institutions. An example of a useful institution in a country where self-dealing is an important risk: rules requiring a new controlling shareholder to offer to buy out all other shareholders at a per share price comparable to the price that the controlling shareholder paid in acquiring control. This rule gives comfort to outside investors that, while they must still bet, to some extent, on the honesty of a company's current controlling shareholders, they have an assured exit, at a reasonable price, if control changes hands.

Still, the list is ample to suggest the difficult task facing a country that wants to control self-dealing well enough to develop a strong stock market. Once again, rules on paper are important but not sufficient. Enforcement is critical. The Russian company law offers a good example. It contains reasonably strong procedural protections against self-dealing transactions. But in practice, Russian companies routinely ignore the rules on self-dealing transactions, because there is no enforcement. Insiders hide the transactions, and (sometimes corrupt) prosecutors and judges usually let the insiders off the hook in the rare case when a transaction is exposed. Reputational intermediaries -- including major investment banks and major accounting firms -- have chosen to look the other way. In an environment where they don't face

appreciable liability risk, they have chosen to squander their reputations rather than lose big Russian companies as clients.²²

(17) Rules ensuring transparency of trading prices.

Insider trading flourishes in the dark. The better the trading price is as a guide to actual value, the harder for insiders to profit from trading with outsiders. This requires not only general financial disclosure, but also rules ensuring transparency of trading.

(18) Rules banning manipulation of trading prices.

The downside of market transparency is that the public reporting of trades permits insiders to manipulate trading prices. "Pump and dump" schemes, where insiders of small companies use prearranged transactions at rising prices to create the appearance of a hot stock, and then sell their own shares at inflated prices, are an endemic problem even in developed markets. Enforcement of antimanipulation rules by specialized regulators is the only remedy.

²² An example: [cite to Wall St. J. article on, and description of Goldman intermediation of Yukos loan].

The length of this list is intended to suggest that developing strong securities markets is a difficult task, not that it an impossible one. Incremental steps can help, at least for large companies that can rely in significant part on their own reputations. Among developed countries, for example, Italy and Germany have taken important steps in the last several years toward improving disclosure.²³ At the same time, these countries have experienced a significant increase in initial public offerings, and in the ratio of market capitalization to GNP. I don't think these changes are a coincidence. It is likely that Italy and Germany would realize even stronger growth in stock market capitalization if they enhanced not only their disclosure rules but also their procedural protections against self-dealing transactions.

But these changes do not come easily. The new German and Italian disclosure rules have been controversial, partly because while they make it easier for new companies to go public, they also transfer wealth in already publicly traded companies from insiders to outside shareholders.

IV. Can Companies and Countries with Weak Institutions Piggyback on Other Countries' Institutions?

Given the difficulty of creating the interrelated institutions that are needed for strong securities markets, an important question is to what extent can a company located in a country that lacks many or all of these institutions piggyback on the institutions of other countries. A related question is to what extent can an entire *country* piggyback on other countries' institutions. This part is devoted to that question. Jack Coffee argues that individual companies can often piggyback on another country's institutions.²⁴ Some piggybacking is surely feasible, but I'm more skeptical about its extent.

Table I lists below the institutions that are necessary for strong securities markets, organized somewhat differently than in Parts II and III in order to emphasize the overlap between the institutions needed to ensure good disclosure (Part II) and to control insider self-dealing (Part III). I also offer in Table 1 my own rough judgments, on a 1-5 scale, on how easily a *company* or an entire *country* can piggyback on foreign institutions. Explanations of each ranking follow the table. A rough translation of the 1-5 scale is:

- 5: easy to piggyback (as easy or nearly as easy as for a company already located in the foreign country)
- 4: piggybacking is feasible, not too difficult, and likely to work reasonably well
- 3: piggybacking is possible but difficult and/or will work only moderately well if achieved
- 2: piggybacking is very difficult and/or won't work very well if attempted

²³ [citations to come].

²⁴ Coffee (1998), *supra* note 2.

1: significant piggybacking is not feasible

The rankings are intended to take us beyond general discussion of the feasibility of piggybacking, into detailed consideration of which institutions can be piggybacked (and how effectively) and which can't, and the local obstacles to effective piggybacking. That, in turn, can inform a local reform strategy that concentrates effort on improving the institutions for which piggybacking is hardest.

Table 1
Ease of Piggybacking on Foreign Institutions

Securities Market Institutions	Needed for:		Ease of Piggybacking	
	Information Disclosure	Insider Self-Dealing	for a Company	for a Country
1. Securities laws requiring full disclosure of financial results and self-dealing transactions	X	X	4	3
2. Strong, publicly enforced civil and criminal sanctions against insiders for violating the disclosure and self-dealing rules	X	X	2	2
3. An honest, sophisticated securities agency (and prosecutors for criminal cases)	X	X	1	1
4. Honest, sophisticated, well-functioning courts	X	X	1	1
5. An active financial press	X	X	2	2
6. A culture of compliance with the disclosure and self-dealing rules by managers, reputational intermediaries, and independent directors	X	X	2	1
7. Good accounting rules	X	X	4	3
8. A good organization to write accounting rules	X	X	4	3
9. Requirements for audited financial statements	X	X	4	3
10. A sophisticated accounting profession	X	X	4	2
11. A sophisticated investment	X		4	2

CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE
Seoul, 3-5 March 1999

Securities Market Institutions	Needed for:		Ease of Piggybacking	
	Information Disclosure	Insider Self-Dealing	for a Company	for a Country
banking profession				
12. Sophisticated securities lawyers	X	X	4	2
13. A stock exchange with meaningful listing standards and an active insider trading surveillance operation	X	X	4	2
14. Market transparency	X	X	5	4
15. A ban on market manipulation	X	X	2	1
16. Civil liability risk for accountants	X	X	3	2
17. Civil liability risk for investment bankers	X		3	2
18. Civil liability risk for insiders	useful	X	1	1
19. Civil liability risk for independent directors if they approve gross self-dealing		X	1	1
20. Auditor review of the adequacy of disclosure of self-dealing transactions		X	3	2
21. Procedural controls on self-dealing transactions (review by independent directors, noninterested shareholders, or both)		X	3	2
22. Independent directors who can control insider self-dealing		X	3	2
23. Ownership disclosure rules		X	4	3
24. Securities or other laws banning insider trading		X	3	2
Mean ranking:			2.96	2.08

Despite the crude, judgmental nature of the rankings, some general themes emerge. First, there are no easily transplantable institutions. There is only one 5 in the table above -- in the company rankings for market transparency, achievable by listing on a transparent foreign stock market. The core problem is local enforcement and local culture. Even world class laws need to be understood and enforced. Understanding depends on local culture, and full enforcement depends on local institutions. Without enforcement, a strong

Seoul, 3-5 March 1999

culture of compliance isn't likely. With neither good enforcement nor good local culture, investors will (rightly) discount the credibility of a company's promise to obey the tougher rules of another jurisdiction – even a promise that is partially well bonded by listing on the other country's stock exchange and hiring internationally known accountants, investment bankers, and lawyers. Moreover, in many countries, only the largest companies can afford to hire world-class accountants, bankers, and lawyers.

It may help to consider a couple of concrete examples. Consider Vimpelcom – a Russian telephone company that went public in the United States, is listed on the New York Stock Exchange, has most of its shareholders in the U.S., and is fully subject to U.S. accounting requirements and securities laws. That effort helps Vimpelcom's shares to trade at higher multiples of expected earnings than a comparable Russian company that follows domestic rules. But investors will still heavily discount Vimpelcom's shares, compared to an American company with the same apparent prospects. They know that Vimpelcom's insiders can cheat and get away with it. In the future, they might decide to do so, no matter how sincere their current promises to the contrary.

Moreover, the strategy of listing shares overseas is always at the mercy of domestic politics. Investors who bought the shares of Malaysian companies on the Singapore stock exchange learned this to their sorrow in 1998, when the Malaysian government declared these shares untradeable. Some Malaysian companies then proved their own untrustworthiness by offering to buy the frozen shares back from investors at a steep discount to market, and the whole mess remained unresolved as of mid-1999.²⁵

Second, an individual company can borrow a reasonable number of institutions from abroad. In 16 of the 24 categories, I rate piggybacking potential for an individual company at 3 or above. Table II provides some simple statistics:

Table 2
Company Rankings for Ease of Piggybacking

Ranking	Frequency
1	4
2	4
3	6
4	9
5	1
mean: 2.96	

Third, it's much harder for an entire country, and thus for its smaller firms, to piggyback on foreign institutions than for a single company to do so. For example, adopting international accounting standards may seem straightforward for a country, just as for an individual company. But for the country as a whole,

²⁵ See *Malaysia's Stockmarket: Daylight Clobbering*, *Economist*, July 10, 1999, at 71.

Seoul, 3-5 March 1999

the feasibility of adopting and implementing a complex set of international rules is limited by the sophistication of the local accounting profession, and the extent to which the country's old accounting rules are tied to local laws, which then must be changed as well.

Table 3 summarizes the country rankings. No institution receives a 5 ranking, only market transparency receives a rank of 4 for piggybacking ease, and 17 of the 24 institutions receive a rank of 1 or 2. The mean rating drops almost a full point, from 2.96 to 2.08.

Table 3
Country Rankings for Ease of Piggybacking

Ranking	Frequency
1	6
2	11
3	6
4	1
5	0
mean: 2.09	

Fourth, the most basic, and hence perhaps most important, institutions are the hardest to transplant. One can't transplant honest or competent regulators, prosecutors or judges. Thus, one can't transplant enforcement against locals – insiders and independent directors. One also can't easily transplant culture, especially without local enforcement to reinforce the cultural norms.

The reasoning underlying these rankings follows.

1. *Securities laws requiring full disclosure of financial results and self-dealing transactions* (company ranking = 4; country ranking = 3).

It is reasonably straightforward, if somewhat costly, for a single company to list on, say, the New York Stock Exchange or NASDAQ and subject itself to U.S. disclosure and accounting rules. The company and its insiders still may not follow them as attentively as an American company, nor as reliably if the company gets into financial trouble and faces a final period problem. Hence the ranking of 4 instead of 5.

For a country as a whole, borrowing disclosure rules isn't as easy. The American securities laws can't be simply copied and transplanted wholesale to another country. An attempt to do so will fail – they won't mesh with other local institutions, will likely conflict with other local laws, will be far more complex than needed, and will in some respects be *weaker* than needed, because official rules can be less strict when informal enforcement is strong. Instead, borrowing securities law from abroad takes careful work, often involving collaboration between domestic draftsmen and foreign experts who can explain how their rules really work.

This is a lot of work. The end product will inevitably be imperfect even before it gets to the legislature. If my own experience (in Russia, Mongolia, Vietnam, and Ukraine) is any guide, the disclosure rules will be

still more imperfect when it emerges from the legislature. Thus, with the exception of accounting rules (discussed below), I can't rate the transplantability of a whole body of law any higher than a 3.

2. *Strong civil and criminal sanctions against insiders for violating the disclosure and self-dealing rules* (company ranking = 2; country ranking = 2).

When it comes to direct sanctions against insiders, there isn't that much that a single company can do. Its foreign assets are potentially vulnerable to a suit in the foreign country where it lists its shares. The company is subject to delisting -- a kind of civil sanction -- if it misbehaves. But both of these exposures are limited, and affect insiders only indirectly, through the shares they own. A company can't do much to create direct enforcement against its own insiders, unless the country chooses to do so.

Countries, too, have a hard time importing strong sanctions. Stronger rules can be adopted, but, especially for criminal rules, they have to fit within an existing legal framework. They can't simply be adopted wholesale, the way that disclosure rules can. Moreover, the rules are, in the end, no better than the enforcement, which can't be imported at all.

3. *An honest, sophisticated securities agency (and prosecutors for criminal cases)*

4. *Honest, sophisticated, well-functioning courts*

For each: company ranking = 1; country ranking = 1

These institutions are at the heart of a good national investor protection system, and are neither transplantable nor easily created.

5. *An active financial press* (company ranking = 2; country ranking = 2)

The financial press must be, for the most part, homegrown, and can't be tailored to the needs of a particular company. And it can be chilled by overly broad local libel rules. At the same time, there is some room for importing foreign reporting standards by welcoming the international financial press (Wall Street Journal, Financial Times, Economist, and the like). These journals can provide some reporting themselves, and also raise local professional standards by example.

6. *A culture of compliance with the disclosure and self-dealing rules by managers, reputational intermediaries, and independent directors* (company ranking = 2; country ranking = 1)

Culture is inherently largely local. A single company can take some steps to import a culture of disclosure and compliance. It can hire foreigners to sit on its board of directors, and in its financial department. That helps, but only so much. The bulk of the staff will be local, and can often hide local skeletons from the foreigners. And their thought processes, as they think about disclosing something they'd rather hide will be influenced primarily by national culture and expectations, not the perhaps different norms their company has tried to instill.

7. *Good accounting rules*

8. *A good organization to write accounting rules*

9. *Requirements for audited financial statements*

For each: company ranking = 4; country ranking = 3

Audit requirements and accounting rules are among the easiest for a company to borrow from abroad. The rules exist in reasonably clear form (the most common choices are U.S. General Accepted Accounting Principles, or the steadily improving International Accounting Standards), as do rule-writing organizations that keep the rules up to date. The company, at some extra cost, can keep two sets of accounts, one following local rules and the second following the chosen international rules, and can hire an international accounting firm to audit its accounts and review its financial statements. Lack of local enforcement will still limit the credibility of the financial statements to some degree. Overall, extra cost and lack of local enforcement explain why this collection of institutions receives a 4 for transplantability, rather than a 5.

At the country level, transplanting accounting rules and audit requirements is not as simple as for a single company. As a formal matter, a country can adopt wholesale a set of foreign accounting rules, including future changes in those rules, and accompanying audit requirements. But the effectiveness of the new rules and audit requirements will depend on the sophistication of the local accounting profession. Any one company can, at some cost, import foreign accountants. A whole country cannot.

The country feasibility rating of 3 is a blend of the 4 rating for an individual company, and the 2 rating for the transplantability of a sophisticated accounting profession. A second reason for the lower country rating is that in the near term, if the local accounting profession is too weak, or too small in number, it may not be practical to adopt international rules, or widespread audit requirements, because there aren't enough trained accountants to implement them.

10. *A sophisticated accounting profession*

11. *A sophisticated investment banking profession*

12. *Sophisticated securities lawyers*

For each: company ranking = 4; country ranking = 2

These reputational intermediaries that support good disclosure in strong securities markets; all but the investment bankers are also important for controlling self-dealing. An individual company can, at a cost high enough to make this feasible only for large companies, hire international accountants, investment bankers, and securities lawyers. This can produce reasonably effective reputational intermediation, albeit still not worth as much as in a jurisdiction with strong local enforcement.

A country can do a little bit to piggyback on the existence of international accounting, investment banking, and law firms. Most obviously, it can permit them to enter, compete with local firms, and hire local people, some of whom will later leave to join local firms or start their own firms. That merits a 2 ranking for ease of piggybacking, but no more than that. The job of building a sophisticated profession remains a decades-long one, that requires an initial investment in university-level education, and in the rules that will create the demand for these skilled professionals, that will lead talented young people to choose these professions.

13. *A stock exchange with meaningful listing standards and an active insider trading surveillance operation* (company ranking = 4; country ranking = 3).

An individual company can list its shares on a foreign exchange; and thereby obtain most of the reputational benefits from doing so.

For a country that wants to build a stock exchange, the rules and trading systems can be imported, though they will surely need to be adapted to local rules and local needs. Another potentially feasible strategy, though so far not a popular one, is to build no stock exchange at all, and expect local firms to list abroad.

These possibilities make stock exchanges easier to borrow than other reputational intermediaries, warranting a 3 ranking.

14. *Market transparency* (company ranking = 5; country ranking = 4)

Of all the institutions in the chart, market transparency is the easiest to transplant. For a company, transparency can be ensured by listing on a foreign exchange in a country with strong transparency rules, and hiring a good registrar, which will refuse to register share transfers that don't comply with the transparency rules. This warrants a 5 ranking.

For a country, the same strategy is feasible. One needs transparency rules for the stock exchange(s), rules on when registrars should record share transfers, plus some ability to enforce the rules against both the exchange and the registrars. Even with the extra enforcement issues, a 4 ranking seems warranted.

15. *A ban on market manipulation* (company ranking = 2; country ranking = 1)

An effectively enforced ban is an important accompaniment to market transparency rules, to make sure that the trading information that is conveyed to investors is an accurate reflection of investor sentiment. Unfortunately, making such a ban effective takes good local enforcement, because whether trading is benign or manipulative depends heavily on local facts – on *who* is doing the trading.

An individual company can be helped somewhat by a good stock exchange-maintained record of trades, and the participating broker-dealer. That warrants a 2 ranking. But for a country, sophisticated enforcement is critical, and can't be imported.

16. *Civil liability risk for accountants*

17. *Civil liability risk for investment bankers*

For each: company ranking = 3; country ranking = 2

A company that offers shares overseas, subject to overseas rules, using international accountants and investment bankers, also subjects the accountants and bankers to foreign liability. But proof problems should not be underestimated. Intermediaries are typically liable only if their conduct is culpable in some way -- whether the degree of culpability be negligence, gross negligence, recklessness, or something else. Proving culpability, when the facts are local and often hard to uncover, will often be a daunting task. Thus, in practice, weak local enforcement capacity reduces the liability risk faced by reputational intermediaries.

A country wanting to create liability often faces the need to change not only its substantive rules, but its procedural rules as well, so that small investors have a way to aggregate their claims. And even if all this is done, on-the-ground enforcement will still be hostage, in large measure, to the strength of local courts.

18. *Civil liability risk for insiders*

19. *Civil liability risk for independent directors if they approve gross self-dealing*

For each: company ranking = 1; country ranking = 1

Seoul, 3-5 March 1999

Insiders and independent directors will generally be locals and hold their assets locally. In practice, they will be liable (if at all) only under local law, which brings us back to local courts, which aren't transplantable, and local rules, which are only moderately transplantable. In practice, cases where foreign investors have successfully obtained damages from locals, even for egregious behavior, are few and far between. Most investors don't even try.

20. *Auditor review of the adequacy of disclosure of self-dealing transactions*

21. *Procedural controls on self-dealing transactions (review by independent directors, noninterested shareholders, or both)*

22. *Independent directors who can control insider self-dealing*

For each: company ranking = 3; country ranking = 2

A country can establish procedural devices such as these to control self-dealing. But the procedures can still catch only a fraction of the self-dealing that insiders engage in and then try to hide. The true independence of independent directors will depend, in significant measure, on the country's cultural norms. And the incentive to self-deal will remain present as long as local enforcement is weak.

23. *Ownership disclosure rules (company ranking = 4; country ranking = 3).*

The analysis here is much the same as for disclosure rules generally. A single company can list on the New York Stock Exchange and subject itself to U.S. ownership disclosure rules. The company and its insiders still may not follow them as attentively as an American company, if the insiders have a reason to conceal their ownership. Hence the ranking of 4 instead of 5.

A country has to fit the rules into its overall legal framework and have some ability to enforce them. For example, if courts don't see immediately that if company A controls company B which controls company C, then A controls C, then disclosure rules that work just fine in a developed country will break down. Given this risk, a ranking of 3 seems appropriate.

24. *Securities or other laws banning insider trading (company ranking = 3; country ranking = 2).*

Insider trading can be banned as a formal matter, but policing it is difficult everywhere, and perhaps almost impossible if local institutions are weak. Much of the proof (A is related to B, who knows C, who actually traded) will be local, and thus perhaps hard to come by. It helps a bit if a particular company is listed on a foreign exchange, with an active surveillance operation. But still, the exchange will usually hit a dead end when it investigated suspicious trading. These pervasive enforcement problems preclude a high ranking.

V. Strong and Weak Securities Markets: A Separating Equilibrium?

Many of the institutions needed to support a strong securities market are endogenous to the existence of that market. For example, if there isn't an active market for public offerings of securities, there is less reason for investment bankers to invest in the reputation needed to support these offerings; less need for a stock exchange to develop strong listing standards; less opportunity for a sophisticated securities regulatory agency, sophisticated accounting rules, and a sophisticated rule-writing body to develop; and so on.

Moreover, if securities markets are weak, companies and countries will develop other ways to finance businesses. Bank financing is an obvious alternative. But bank-dominated financing leads to strong banks, both financially and politically. The banks will resist legal changes that might strengthen securities markets. Family-run conglomerates are a second alternative. Once built, they reduce the need for a strong securities market, and their insiders will fight against rules and institutions that limit self-dealing between group members.

The converse is also true. A country with a strong securities market will build supporting institutions, that will provide political support for the rules and official enforcement that are needed to maintain a strong market. In the United States, the Securities and Exchange Commission is a strong regulator in no small part because the securities and mutual fund industries want it to be. A country with a strong securities market is more likely to build a venture capital industry, which both depends on the possibility of exit from portfolio investments through an initial public offering and generates demand for the institutions that support these public offerings.²⁶

Thus, for both economic and political reasons, there is the potential for two separate, stable equilibria to arise -- a strong market equilibrium, in which the necessary endogenous institutions have been built and are politically stable, and a weak market equilibrium in which many of the necessary institutions are absent and building them faces strong political opposition.

I intend the concept of a separating equilibrium to be a qualitative one. Incremental improvements in a country's securities market are possible. Even in the weak market equilibrium, some companies can develop reputations strong enough to obtain respectable prices when they sell shares to outside investors. The better a country's institutions, the more companies will be able to sell shares, relying partly on their own and partly on the country's reputation.

Nonetheless, the concept of separating equilibria can capture the difficulty a country is likely to face in moving from a bank-centered capital market, where mature companies go public largely based on their own reputations, to a stock-market-centered capital market where new companies have access to public capital because they can trade on the built-up reputations of others, especially reputational intermediaries, and on factors like culture and enforcement that make fraud or self-dealing less likely among companies that haven't yet built their own reputations. Parts II and III of this article can be seen as an attempt to develop minimum conditions for a country to achieve the "strong markets" equilibrium.

VI. Different Types of Monitoring: Investor Protection and Firm Performance

²⁶ See Black & Gilson (1998), *supra* note 10.

A major theme in comparative research on corporate governance over the past decade is the effort to assess the comparative strengths and weakness of bank-centered and stock-market-centered capital markets. The standard debate posits that bank-centered capital markets, such as Germany and Japan, have a potential advantage over stock-market-centered capital markets in the ability of investors to directly monitor managers, to make sure that the company is well-managed. Strong banks have greater ability to monitor than dispersed shareholders. That insiders in the company or the overseeing bank won't simply steal from the company through self-dealing transactions is taken for granted.²⁷

The standard analysis recognizes that stock-market-centered capital markets also have potential advantages. For one thing, banks may discourage risk-taking, in order to protect their mostly fixed claims. They may monitor more strongly than dispersed shareholders, but in a skewed way. Stock-market-centered systems can also provide greater liquidity to investors, and greater capital-raising opportunities for companies with intangible assets, against which banks can't easily lend. They can develop an active market for corporate control, that can provide indirect monitoring of performance and substitute in part for the weak direct monitoring that characterizes capital-market-centered systems.

²⁷ For pieces of this extended debate, see **Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*** (Princeton Univ. Press 1994); Black & Gilson (1998), *supra* note 9; John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 **Columbia Law Review** 1277-1368 (1991); Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 **Wash. U.L.Q.** 327 (1996).

Seoul, 3-5 March 1999

Moreover, bank-centered systems tend to foster family-controlled conglomerates that create internal equity capital markets, to replace the weak external equity markets. Especially in economic downturns, these conglomerates often send good money after bad in an effort to prop up moneylosing subsidiaries. And many conglomerates that do well when run by a first-generation entrepreneur run into trouble once the heirs take control.²⁸

Still the debate proceeds from a central, widely accepted premise -- that the more concentrated ownership that characterizes bank-centered capital markets can potentially produce stronger monitoring than stock-market-centered systems. The analysis developed above suggests that this assumption may be misplaced, at least as applied to a less developed economy. Monitoring has two basic dimensions -- monitoring management performance, to ensure that a company is well run, and monitoring insiders, to ensure that they don't steal the company's value from investors (shareholders or creditors). I have suggested above that strong securities markets develop only in countries that do a good job along the second dimension. -- protecting outside investors against insider self-dealing. This raises the possibility that countries with stock-market-centered systems systematically have stronger monitoring along this dimension than countries with bank-centered systems. That monitoring strength could compensate for their (conceded, for purposes of this argument) weaker monitoring of management performance. And it may even be that bank-centered systems develop in part because an important partial predictor of

I do not propose to answer that question here, merely to raise it. Answering it is difficult, in part because bank-centered systems may do a good job of protecting creditors against insider theft, at the same time that they don't protect minority equity investors so well against transfer of value from those investors to insiders. Indeed, a strong bank-centered capital market *must* do a respectable job of protecting creditors, or bank finance won't be widely available either.

Still, it is plausible that, on the whole, stock-market-centered capital markets are stronger than bank-centered capital markets in ensuring that companies are *honestly* run. Indeed, a country's success along this dimension may be an important, albeit partial predictor of what kind of capital market it develops. If so, then the two systems would have different monitoring strengths, with neither clearly dominating the other along an overall monitoring dimension.

Put differently, the greater liquidity offered by stock-market-centered capital markets may *not* come at a cost in weaker monitoring, once monitoring is understood to include both controls against weak management (on which corporate governance scholarship usually focuses) and controls against self-dealing

²⁸ See Randall K. Morck, David A. Stangeland & Bernard Yeung, *Inherited Wealth, Corporate Control and Economic Growth: The Canadian Disease?* (National Bureau of Economic Research working paper No. _____, 1999) (reporting evidence of weak performance by heir-controlled Canadian firms).

(which are often taken for granted in the United States, but loom large elsewhere). At the same time, this broader conception of "monitoring" suggests a reframing of the standard "corporate governance" debate over how to improve monitoring in a way that gives greater weight to financial reporting and control over insider self-dealing.

VII. Conclusion: What Steps to Take First

The complex institutions needed to support a strong securities market can't be developed overnight, or all at once. Some, like honest courts and prosecutors, can precede market development. Others will grow only as the market itself grows. For example, a country can hardly develop a strong securities regulator before it has some publicly traded securities for the regulator to gain experience with.

Many transition economies have none, or almost none, of the needed institutions. Where should they start? There are two obvious places to start. The first area of emphasis should be on institutions that must be homegrown, including honest courts and prosecutors, and some experience in applying rules against fraud in complex white-collar crime cases. The second is good capital markets rules, which have the helpful feature that in important respects, they can be imported from outside. The importing country needs to understand that if it engages five sets of foreign advisors, they will propose five different laws, which will be inconsistent with each other and with the country's existing laws. Local draftsmen need to be closely involved in the drafting process, to ensure that the rules fit into an existing legal framework and that the rules build on existing terminology and practice to the extent possible.

Accounting rules are a central part of information disclosure. Here, fortunately, we are not far (perhaps 5 years) away from having a perfectly workable set of international accounting standards that a developing country can draw on in preparing its own rules, or even adopt wholesale.²⁹

Another important step, if professional intermediaries don't exist, is establishing or strengthening good professional schools in business (for investment bankers and accountants) and law (for securities lawyers and regulators). The payoff for this investment in training of young people will be measured in decades. But if the investment isn't made, the decades will go by, and the country still won't have the prerequisites it needs.

None of this will happen quickly. But some basic, early steps -- honest courts; regulators and prosecutors -- are critical whatever form a country's capital markets take. It is no harder to develop honest, sophisticated securities regulators than to develop honest, sophisticated bank regulators. One suspects also that government honesty has important externalities -- one agency is unlikely to be an island of honesty in a sea of corruption.

²⁹ [cite to International Accounting Standards].

CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE

Seoul, 3-5 March 1999

In developed countries, scholars often think of good corporate governance as revolving around such matters as subtle variations in the independence of directors, or the constraints on the corporate control market. In developed countries, corporate governance can be much more basic. We need honest judges and regulators before it makes sense to start worrying too much about independent directors.