Atualidades

STRENGTHENING BRAZIL'S SECURITIES MARKETS

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Introduction. Information Asymmetry: Information Asymmetry as an Adverse Selection Problem; Information Asymmetry Institutions. Controlling Self-Dealing: Types of Self-Dealing; The Structure of the Self-Dealing Problem; Brazilian Political Opposition to Stronger Controls on Self-Dealing; Institutions that Control Self-Dealing. Piggybacking. Assessing Brazil's Institutions. Conclusion.

Introduction

This paper is an expanded version of a speech that I gave at the Sao Paolo Stock Exchange (Bovespa) in August 2000. In it, I apply the principles developed in my paper, *The Legal and Institutional Preconditions for Strong Securities Markets*, to the Brazilian situation.[1] I discuss the strengths and weaknesses of Brazil's institutions, with the goal of offering a tentative roadmap for future reforms. An important caveat: I have limited knowledge of Brazil's capital markets, and may err in my understanding of Brazil's institutions and how they might be improved.

I have spent substantial time, since 1993, working on privatization, company law, and securities law in a number of developing countries, including Armenia, Indonesia, Korea, Mongolia, Russia, Ukraine, and Vietnam. Some of these countries have tried to make the leap from a centrally planned economy to a strong public stock market. They have failed. The most aggressive efforts, in Russia and the Czech Republic, have crashed and burned. The Czech Republic, for example, created around 2,000 public companies through mass privatization. Today, only about 10 companies are actively traded. The market capitalization of Russian companies is astonishingly low — perhaps .001 (0.1%) of the value these companies would have if operated in a developed country and valued at developed country multiples.[2]

We are learning from this experience how critical various government and market institutions are for privatization, a market economy in general, and a securities market in particular. Building a strong securities market is hard to do *at all*, and im-

1. Bernard Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 *UCLA Law Review* (forthcoming 2001), available from Social Science Research Network at http://papers.ssrn.com/paper.taf?abstract_id=182169.

2. On mass privatization in Russia and the Czech Republic, see Bernard Black, Reinier Kraakman & Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 *Stanford Law Review* 1731-1808 (2000), available from Social Science Research Network at http://papers.ssrn.com/paper.taf?abstract_id=181348.

possible to do quickly. The central reason why building a strong securities market is so hard is that the securities market depends on a complex network of supporting institutions, including government regulations; enforcement agencies; private market institutions; and a culture of disclosure and honest dealing with minority shareholders. These intricate systems are not easy to build.

Public securities markets involve a kind of magic. 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. An important reason why this magic is rare internationally is that it is hard to develop the interrelated institutions that support these markets.

I will focus on the requirements for a strong securities market in the context of a public offering of common shares, often by a company that is selling shares to the public for the first time. In my view, there are two conditions that are necessary but not sufficient for a country to have a strong stock market. 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 they will not be cheated out of that value by a company's insiders (its managers and controlling shareholders) through self-dealing transactions.

The caveat that these conditions are necessary but not sufficient is important for Brazil. Brazil has a history of high inflation, government currency controls, and even freezes on bank accounts. Investors will remember these problems long after the problems themselves recede. The risk of high inflation alone is sufficient to suppress markets for long-term debt. Yet in other countries, debt markets are often a precursor to strong equity markets. Political risk, including currency controls and bank account freezes, make investors reluctant to hold assets in Brazil in visible form – and investments in public securities are as visible as one can get.

Brazil's high value-added taxes add a further obstacle to a strong stock market: They make it attractive for companies with significant exports to remain private, the better to evade taxes by selling their output at a below-market price to a foreign intermediary, which can resell at the market price. If U.S. experience is any guide, these tax evasion strategies are very difficult to control; the only long-term response may be to reduce the tax rate. But let me put these Brazil-specific problems aside, and return to the core of my paper.

Information Asymmetry

One critical obstacle to strong stock markets is *asymmetric information*. The value of a company's shares depends on the company's future prospects. The company's past performance is a partial guide to its future prospects. The company's insiders know about its past performance and its future prospects. Investors do not know this information. The insiders have information; investors need information.

Delivering information to investors is easy, but delivering *credible, believable* information is hard. Insiders have an incentive to hide problems and exaggerate the company's past performance and future prospects. Investors cannot directly verify the information that the company provides.

Information Asymmetry as an Adverse Selection Problem

In the terminology of modern economics, securities markets are a good example of what Americans call a market for "lemons", because a lemon is a fruit with a sour taste. A lemon is a slang term for a used car. The car has something wrong with it. The buyer discovers this only after he buys the car, and is then unhappy with his purchase. Buyers of used cars know that some cars are lemons, but they don't know which ones, so they offer lower prices for all used cars.

The same thing happens for securities. Investors don't know which companies are truthful and which are not truthful, so they offer lower prices for the shares of *all* companies. This may ensure that investors receive a fair price, on average. But now consider an honest company that reports truthfully to investors, and whose insiders will not divert some or all of the company's income stream to themselves.

Lower share prices mean that an honest company cannot receive a fair price for its shares. The honest company has an incentive to turn to other forms of financing. But lower prices will not discourage dishonest companies. The prospect of receiving even a low price for a worthless piece of paper will be attractive to some insiders.

The term that describes this process, in which honest companies decide not to issue shares, while dishonest companies continue to issue shares, is "adverse selection". This term comes originally from insurance markets. The idea, in insurance, is this: Health insurance is a better buy for sick people than for healthy people. Therefore, sick people are more likely to buy health insurance. This drives up the cost of insurance, which discourages healthy people from buying it. The average buyer of health insurance is therefore even sicker, which discourages still more healthy buyers, which drives up the price even further, and so on.

In securities markets, adverse selection means that a higher fraction of companies are offering lemons for sale. Investors react to the lower average quality of shares by reducing still more the prices they will pay. This drives even more high-quality companies away from the stock market and exacerbates the adverse selection problem.

To give a flavor for the severity of the lemons problem for securities, let me compare it to the example of used cars. For a used car, you can look at the car, drive it, hire a mechanic to inspect it, and rely on the manufacturer's reputation. In contrast, a company is like a unique, unobservable car. You cannot look at it. You cannot have it inspected by your own mechanic. You cannot take it for a test drive. You cannot determine the history of other cars produced by the same manufacturer, because there are no similar cars. Instead, you get a dry written report by the *company's* mechanics, who are known as accountants.

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 comfort that companies that issue shares are being mostly truthful. Among the most important institutions are reputational intermediaries — accounting firms, investment banking firms, law firms, and stock exchanges — who vouch for the quality of securities. These intermediaries are credible because they are repeat players who will suffer a loss of reputation if they let a particular company exaggerate its prospects, that exceeds the intermediary's one-time gains from permitting the exaggeration. The intermediary's willingness to say no to a client is reinforced by legal liability if the intermediary approves false disclosure, and by government prosecution if the intermediary *intentionally* approves false disclosure.

But even in the United States, we have a major problem with "securities fraud" — the effort to sell shares at an inflated price through false or misleading disclosure. Dishonest salesmen can sell fraudulent securities partly because the United States' *very success* in creating an overall climate of honest disclosure leads investors to be less careful in investigating claims by persuasive salesmen about particular companies. Investors' willingness to accept claims about a company's bright future creates fertile soil for fraud.

Most American investors still expect securities to be vouched for by reputational intermediaries. They expect financial statements to be audited; they expect shares to be sold through an underwriter; they expect the prospectus to be prepared by securities lawyers. But this merely recreates the fraud problem one step removed. The United States' success in creating an environment, in which most reputational intermediaries protect their reputations, creates an opportunity for new entrants to *pretend* to be reputational intermediaries. Merely calling yourself an investment banker will lead investors to trust you, because most investment bankers are honest.

In effect, any one investment banker (or accountant or securities lawyer) cannot fully capture its own investment in reputation. Some of that investment spills over and enhances the reputation of the entire profession. In welfare economics, this is called an "externality". The spillover of reputation to the whole profession lets other people — whom I will call "bogus investment bankers" — profit by pretending that their action in underwriting a company's shares has reputational value. In effect, the bogus investment banker steals some of the value of its competitors' reputations while reducing the value of those reputations, because bad reputations spill over to the whole profession just as good ones do.

The result is ironic: The principal role of reputational intermediaries is to vouch for the quality of disclosure and thus reduce information asymmetry. But information asymmetry *in the market for reputational intermediaries* limits their ability to play this role. Common solutions involve legal rules that make the intermediaries liable to investors and government policing of the reputational intermediaries, including licensing, revoking the licenses of misbehaving intermediaries, and occasional criminal prosecution.

The resulting system, in which multiple reputational intermediaries vouch for different aspects of a company's disclosure, and private plaintiffs and the government police the reputational intermediaries, can work tolerably well. But it is not simple. This complex response to information asymmetry helps to explain why many countries have not solved the information asymmetry 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 companies 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 no direct access to public investors' capital. They must obtain capital from intermediaries, usually banks, or else grow only at the rate permitted by reinvestment of past earnings.

Information Asymmetry Institutions

Successful securities markets have developed a number of institutions to counter information asymmetry. In *The Legal and Institutional Preconditions for Strong Securities Markets*, I develop and defend a list of 18 core institutions, plus about 10 more useful institutions. Below, I merely list the core institutions. Readers will have their own opinions about whether my list is a good one, and about which institutions Brazil has, and which it does not have. The institutions are:

Category 1: Effective Regulators, Prosecutors, and Courts

(1) A securities regulator (and, for criminal cases, a prosecutor) that (i) is honest; and (ii) has the staff, skill, and budget to pursue complex securities cases.

(2) A judicial system that (i) is honest; (ii) is sophisticated enough to handle complex securities cases; (iii) can intervene quickly when needed to prevent asset stripping; and (iv) produces decisions without intolerable delay.

(3) Procedural rules that provide reasonably broad civil discovery and permit

class actions or another means to combine the small claims of many investors.

Category 2: Financial Disclosure Institutions

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

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

(6) A rule-writing institution with the competence, independence, and incentives to write good accounting rules and keep the rules up to date.

Category 3: Reputational Intermediaries

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

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

(9) A sophisticated investment banking profession that investigates securities issuers because the investment banker's reputation depends on not selling overpriced securities to investors.

(10) 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.

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

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

Category 4: Liability for Companies and Insiders

(13) Securities or other laws that impose liability and other civil sanctions on companies and insiders for false or misleading disclosure.

(14) Criminal sanctions against insiders who intentionally mislead investors.

Category 5: Market Transparency

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

(16) Rules banning manipulation of trading prices (and enforcement of those rules).

Category 6: Culture and Other Informal Institutions

(17) An active financial press and securities analysis profession that can uncover and publicize misleading disclosure.

(18) A culture of disclosure 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 misdisclosure reinforce a culture of compliance, in which a bit of puffing is acceptable, but outright lying is not. Accountants, investment bankers, and lawyers see themselves as professionals, and (mostly) behave accordingly. Moreover, few insiders attempt clearly illegal actions, because disclosure is the norm and others are sometimes disgraced or sent to jail for falsifying financial statements.

These institutions are interrelated and cannot be developed overnight. When I have presented this analysis before, it is rare for anyone to suggest that the institutions that I list are not important. More often, they suggest still more core institutions. Ensuring good information disclosure is simply a tough job.

Controlling Self-Dealing

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 to convey 80% or 90% or even 100% of the company's value. This risk of insider "self-dealing" creates a lemons or adverse selection problem, which has the same structure as the adverse selection problem created by asymmetric information.

Types of Self-Dealing

Self-dealing can be *direct*, where a company engages in transactions, not on arms-length terms, that enrich the company's insiders, their relatives, or friends, or a second company that the insiders control. Or it can be *indirect* (often called *insider trading)*, where insiders use information about the company to trade with less-informed investors.

Direct self-dealing is a much more important problem than insider trading. First, it is far more profitable. Direct self-dealing let insiders can turn 50% ownership (say) of shares into 100% ownership of profits, with little additional investment. Insider trading cannot produce similar gains. For one thing, insider trading in significant volume requires a liquid stock market, which countries that do not control direct self-dealing will not have. Also, long-term buy-and-hold investors are not directly harmed by insider trading. You can only be on the losing side of a trade with an insider if you're trading.

More critically, if direct self-dealing is hard to control, insider trading in anonymous securities markets is even harder to control. Without the institutions that control direct self-dealing, a country can't hope to control insider trading. But the converse isn't true. A country can control direct self-dealing fairly well without making the additional investment needed to address insider trading.

The Structure of the Self-Dealing Problem

Self-dealing has the same structure as information asymmetry. Investors do not know which insiders are honest, and which will keep for themselves most or all of the company's value. Investors therefore reduce the prices they offer for the shares of all companies. This creates a dilemma for an honest company, whose insiders will not divert income to themselves. Lower share prices mean that an honest company cannot receive a fair price for its shares, and has an incentive to use other forms of financing. But lower prices will not discourage dishonest companies. The prospect of receiving even a low price for worthless paper will be attractive to some insiders.

This adverse selection by companies, in which high-quality companies leave the market while low-quality companies remain, increases the proportion of low-quality issuers of shares. Investors react to the lower average quality of companies that issue shares by lowering still more the prices they will pay. This drives even more high-quality companies away from the market and exacerbates the adverse selection problem. As with asymmetric information, failure to control self-dealing can produce a "death spiral", in which self-dealing and adverse selection combine to drive almost all honest companies out of the stock market, and drive share prices to zero.

The problem of self-dealing is even harder to solve than information asymmetry. First, honest disclosure of information during a public offering of shares cannot be undone once the offering is completed. In contrast, once a company sells shares, the company's insiders can always renege on a promise not to self-deal.

Indeed, insiders have an incentive to renege and to capture more of the company's value for themselves than investors expected when they bought shares. Again, insurance terminology is helpful — the incentive to renege on a promise not to self-deal is known as moral hazard. The incentive to renege is partly controlled by the insiders' concern for reputation, to permit future share issuances. But concern for reputation can fade quickly when a company gets into trouble. Unless controlled, moral hazard can be sufficient by itself to cause a public stock market to collapse.

A second reason why controlling self-dealing is harder than ensuring good information disclosure: False or misleading disclosure in a public offering often occurs in a written disclosure document. If business problems surface later, the disclosure deficiencies will often be obvious enough to permit regulators or investors to seek sanctions against the insiders and the reputational intermediaries. In the United States, we have aggressive class action lawyers who seek damages against reputational intermediaries in almost all cases of false or misleading disclosure, whether appropriate or not. This is not entirely good, because it drives up the cost of securities offerings. But it also provides an incentives for intermediaries to be careful — more careful, I believe, than the exact same intermediaries will be in Brazil, where they face little risk of liability. For self-dealing, the solution of relying on reputational intermediaries, and suing them when they endorse false or misleading disclosure, is harder than for information asymmetry. Self-dealing is often hidden — it must be uncovered before it can be policed.

A third reason why self-dealing is harder to control than information asymmetry: Once a company issues shares at a reduced price, in a market with information asymmetry, insider self-dealing, and resulting adverse selection and moral hazard, insiders may feel *entitled* to appropriate most of the company's value for themselves. Let me explain why insiders can feel this way with an example.

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 are willing to pay only 50¢ per share, because they expect insiders to keep most of the company's value for themselves. Suppose now that Company *A* issues 50 additional shares, for a total 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 keep only 50% of the company's value, they have cheated themselves. Their shares will be worth only $62.50. The insiders' rational response is to self-deal enough to capture at least 80% of the firm's value — $100 out of $125. They will fight against reforms that will prevent them from taking what they see as their fair share of the company's value.

Finally, insiders' concern for reputation cannot, by itself, sustain dispersed ownership, without a controlling shareholder. If a firm with honest insiders, in a market with weak institutions, somehow develops dispersed ownership, that ownership is unstable. A dishonest person can profit by buying a control stake in the market and looting the firm. The Czech Republic offers a recent real world example of this process.

Brazilian Political Opposition to Stronger Controls on Self-Dealing

This political dynamic is found in many countries, and Brazil is no exception. It is no surprise that the managers and controlling shareholders of already public companies have formed the principal political opposition to the current proposals for reform of Brazil's company law. Nor is it surprising that they have enough political strength so that the proposals, not that far-reaching to begin with, have been weaken to the point where, in my judgment, they won't do much to control self-dealing even if adopted.[3] Let me offer two examples.

First example: a board seat for preferred shareholders. The current reform proposal would give preferred shareholders,

3. See *Draft Amendments to the CVM and Capital Markets Law* (Law n. 6,385/76 and the Corporations Law (Law n. 6,404/76) (Rep. Antonio Kandir's draft, as approved by the Finance and Tax Commission on June 7, 2000).

who in substance own nonvoting common shares, the right to a representative on the board of a public company. But this reform, useful in itself, is then undercut severely in multiple ways. First, the director elected by the preferred shareholder must be "adequately qualified", whatever that means. Second, only shareholders who proof that they have held preferred shares for at least 3 months preceding the election have the right to vote in this election. Third, shareholders cannot vote to elect two directors in companies with the same "predominant social objectives" (competitors, that is). Fourth, if half or more of the shareholders who elect such a director sell their shares, the director loses his seat. Finally, the shareholders who elect the director are jointly and severally liable for misdeeds of the director that violate the law or the company's charter, if they elect a person that they know was morally or technically unsuitable! None of these limits apply to the directors elected by the common shares and thus, in most cases, by the controlling family.

This combination of confusing, difficult-to-implement rules, layered on top of the astonishing *in terrorem* provisions that shareholders can be held liable for a director's misdeeds, will likely ensure that this nominal right is rarely used. Institutional shareholders, who are the obvious candidates to exercise this right, will be deterred by liability risk, and will often be aren't disenfranchised because they own shares in two or more competing companies. One assumes that this is precisely the intent behind these requirements.

Second example: a takeout bid requirement for common shares but not preferred shares. Until 1997, Brazil had a "takeout bid" rule that required a new controlling shareholder to offer to buy out all minority shareholders at the same price paid for control. The Brazilian government repealed this rule so that it could privatize controlling stakes in state-owned companies, without complying with the rule. The current proposal would reinstate the takeout bid requirement. But the requirement would apply only to common shares, not to the preferred shares (read: nonvoting common shares) that form 2/3 of the share capital of many major companies. That robs the takeout bid requirement of most of its bite.

Consider, for example, a firm with 2/3 of its share capital in the form of preferred shares, and a controlling family that owns 50% of the common shares. If the proposal is adopted, then if the controlling family sells its shares, the buyer will have to offer to buy the other common shares as well — that is, to buy 1/3 of the total shares instead of 1/6. That isn't enough to dissuade buyers from acquiring control with the intent of cheating minority shareholders of much of the company's value through self-dealing.

Institutions that Control Self-Dealing

Just as successful securities markets have developed institutions to counter information asymmetry, they have developed institutions to counter self-dealing. Some of these are the same institutions that control information asymmetry; some are different institutions. In *The Legal and Institutional Preconditions for Strong Securities Markets*, I again develop and defend a long list, this time of 20 core institutions. The list follows:

Category 1: Effective Regulators, Prosecutors and Courts

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

(2) A judicial system that is (i) honest; (ii) sophisticated enough to understand complex self-dealing transactions; (iii) can intervene quickly when needed to prevent asset stripping; and (iv) can produce decisions without intolerable delay.

Comment: Honest, decently funded judges, regulators, and prosecutors are, if anything, even more critical for controlling self-dealing than for controlling information asymmetry, because reputational intermediaries play a smaller role for self-dealing transactions.

(3) Procedural rules that provide reasonably broad civil discovery, permit class actions or another means to combine the small claims of many investors, and accept proof of self-dealing through circumstantial evidence.

Category 2: Disclosure Requirements and Procedural Protections

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

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

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

(7) A good overall financial disclosure regime.

Comment: Good overall financial disclosure makes it harder to hide direct self-dealing and reduces the profit opportunity from insider trading.

Category 3: Reputational Intermediaries

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

Comment: Insiders have an incentive to hide self-dealing. Unlike the situation when a company issues shares to investors, investors cannot directly insist that reputational intermediaries review self-dealing transactions. Thus, this review must be mandated by law or stock exchange rule.

(9) A sophisticated accounting profession with the skill and experience to catch some non disclosed self-dealing transactions and insist on proper disclosure.

(10) Securities or other laws that impose on accountants enough risk of liability to investors, if the accountants endorse false or misleading disclosure of self-dealing transactions, so that the accountants will search vigorously and resist their clients' entreaties to let them hide or mischaracterize self-dealing transactions.

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

(12) Law or customary practice law that (i) requires public companies to have a minimum number of independent directors; (ii) ensures that the independent directors approve self-dealing transactions; and (iii) imposes on companies and independent directors enough risk of liability if they approve self-dealing transactions that are grossly unfair to the company so that the directors will resist the insiders' pressure to approve these transactions.

Category 4: Insider Liability

(13) Strong civil sanctions against insiders for violating the rules governing self-dealing transactions and insider trading.

(14) Criminal sanctions for intentional violations of the self-dealing rules.

Category 5: Institutions to Control Insider Trading

I have thus far focused on the institutions needed to control direct self-dealing. I list next the additional core institutions that are needed to control insider trading.

(15) Securities or other laws that prohibit insider trading, suitably defined, and government enforcement of those rules.

(16) A stock exchange with meaningful listing standards, the willingness to fine or delist companies that violate the self-dealing rules, and the resources to run a surveillance operation that can catch some insider trading.

(17) Rules ensuring transparent trading prices.

(18) Rules banning manipulation of trading prices (and enforcement of those rules).

Category 6: Culture and Other Informal Institutions

(19) An active financial press and an active securities analysis profession that can uncover and publicize instances of insider dealing.

(20) A culture of compliance among accountants, lawyers, independent directors, and company managers, that concealing self-dealing transactions, approving a seriously unfair transaction, or trading on inside information is improper and a recipe for trouble.

In countries with strong securities markets, the sanctions against direct and indirect self-dealing are strong enough to reinforce a norm against this conduct. That culture reduces the frequency of self-dealing and improves the quality of the transactions that occur. Like the related norms supporting good disclosure and establishing value maximization as a managerial goal, the norm and the supporting institutions likely develop together and reinforce each other.

To take a recent Russian example, it would never occur to an American oil company's managers to propose (as Russian oil company Yukos did in 1999) that the company sell its oil to unknown offshore companies for $1.30 per barrel when the market price was $13. The managers wouldn't propose this, the independent directors wouldn't approve it, and if it somehow occurred anyway, the press would report the scandal and the managers would face both civil and possible criminal liability. In Russia, the press reported some of the scandal, but the managers went ahead anyway.

Piggybacking

The third major topic I address in *The Legal and Institutional Preconditions for Strong Securities Markets* is how easy it is for companies to piggyback on foreign institutions, when their home institutions are weak, and how easy it is for an entire country such as Brazil to piggyback on foreign institutions. In my opinion, some critical institutions, especially local enforcement, cannot be imported from the outside.

I defend that view through a detailed assessment of each institution. The two lists above of core institutions for controlling information asymmetry, self-dealing, or both contain a total of 25 institutions. I rank each of these institutions on a 1-5 scale for ease of piggybacking (1 = impossible; 5 = easy), based on my personal and subjective views about how easy it is to borrow foreign institutions. I conclude that it is possible for an *individual company* to piggyback on foreign institutions moderately well. The mean ranking is 3.12. For an entire country, piggybacking on foreign institutions is much harder. The mean ranking is only 2.12.

While it is easy to disagree with my individual rankings, I have more confidence in this overall assessment — piggybacking is partially possible for a single company, but quite hard for an entire country. I present the specific rankings below, together with my analysis of how Brazil stands with respect to each of these institutions.

Assessing Brazil's Institutions

I discuss below where Brazil now stands with respect to each of the institutions that I consider core for controlling information asymmetry, self-dealing, or both. The table also provides my judgments on the each of piggybacking for each institution.

<table>
<tr><th rowspan="2">Core Institutions</th><th colspan="2">Needed for:</th><th colspan="2">Piggybacking Ease:</th></tr>
<tr><th>Information Asymmetry</th><th>Self-Dealing</th><th>for Company</th><th>for Country</th></tr>
<tr><td>Local Enforcement and Culture</td><td></td><td></td><td></td><td></td></tr>
<tr><td>1. An honest, sophisticated securities agency (and prosecutors for criminal cases)</td><td>X</td><td>X</td><td>1</td><td>1</td></tr>
<tr><td colspan="5">Brazil: The Brazilian Securities Commission (CVM) is honest, I am told. But it has a very limited staff and budget, and is not yet sophisticated enough, in my judgement, to catch subtle forms of misdisclosure or self-dealing. There are also no specialised prosecutors with the skill to bring complex securities cases, and prosecutors have a reputation for not always being honest. On this critical dimension, which cannot be borrowed from abroad, Brazil has important steps that still need to be taken.</td></tr>
<tr><td>2. Honest, sophisticated, well-functioning courts</td><td>X</td><td>X</td><td>1</td><td>1</td></tr>
<tr><td colspan="5">Brazil: Brazilian courts are honest, but not sophisticated, I am told. A specialised commercial court does not exist. From my understanding of the relevant law, the state courts in Sao Paolo and Rio could create specialised commercial courts if they wanted to do so, but are not currently convinced that this is an important step to take. The current proposal to amend the company law to allow companies to provide in their charters for mandatory arbitration of disputes between companies and investors is very interesting. This could provide away around the weakness of the courts. By way of comparison, the U.S. system for arbitration of securities disputes works fairly well, on the whole, in my judgement. I strongly support this proposal. Indeed, in proposing company law reform in other countries, I have more than once offered a similar proposal, only to be told by local lawyers that the proposal was not politically feasible, not practically feasible, or both. I recommend that CVM should have authority to specify which arbitration procedures and which arbitration agencies are acceptable, after reviewing how arbitrators are selected and the procedures that the arbitration agency uses for securities cases.</td></tr>
<tr><td>3. Good civil discovery rules and a class action or similar procedure</td><td>X</td><td>X</td><td>1</td><td>2</td></tr>
<tr><td colspan="5">Brazil: Brazil has reasonable civil discovery rules, I am told, and a procedure for derivative suits that provides reasonable incentives for lawyers and shareholders to bring these cases. It does not yet have a class action mechanism, which can be important for securities cases.</td></tr>
<tr><td>4. A culture of compliance with disclosure and selfdealing rules by insiders, reputational intermediaries, and independent directors</td><td>X</td><td>X</td><td>2</td><td>1</td></tr>
<tr><td colspan="5">Brazil: Brazil does not yet have a strong culture of compliance with disclosure rules, I am told. This culture is likely to improve over time if enforcement improves.</td></tr>
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Disclosure Rules				
5. Rules requiring full disclosure of financial results and self-dealing transactions	X	X	4	3
Brazil: ***Brazil has reasonably strong financial disclosure rules for public companies, I am told. It does not yet have strong rules for disclosure of self-dealing transactions.***				
6. Good accounting rules	X	X	4	3
Brazil: ***Brazil has world-class accounting rules, I am told, deriving in part from past efforts to develop rules that will provide useful informations even in an environment of very high inflation. I expect that over the next 10 years, most of the world will move toward U.S. or British GAAP (generally accepted accounting principles) or toward International Accounting Standards. Brazil is well positioned for this transition.***				
7. Requirements for audited financial statements	X	X	4	3
Brazil: ***Audited statements are required for public companies. However, I understand that many private companies do not have audited financial statements, and that the need to prepare audited financial statements is a disincentive to going public. The disincentive for private companies to prepare audited financial statements involves both the direct cost of the cost and the indirect cost of higher taxes: a company with audited financial statements has a more difficult time hiding its income from tax collectors. Perhaps private companies over a certain size should be required to prepare audited financial statements, even if these statements are not disclosed to the public. I do not yet understand why U.S. private companies, over a certain size, routinely obtain audited financial statements, and their lenders insist that they do so, but Brazilian private companies do not, and their lenders do not insist on audited financial statements. The opportunity for unaudited Brazilian companies to evade taxes may be the principal reason for this difference.***				
8. Ownership disclosure rules		X	4	3
Brazil: ***Brazil's ownership disclosure rules seem adequate to ensure that investors understand who is the controlling shareholder or group of a particular company, and how many shares they own.***				
Reputational Intermediaries and Independent Directors				
9. A sophisticated accounting profession	X	X	4	2
Brazil: ***Brazil has a reasonably sophisticated accounting profession, I am told, and most public companies use one of the big-5 international accounting firms. However, without a meaningful risk of liability for bad audits, even big-5 firms sometimes do sloppy work. For example, some major banks have been found to have assets far less than liabilities soon after getting clean audits from major accounting firms.***				
10. A sophisticated investment banking profession	X		4	2
Brazil: ***Brazil has reasonably sophisticated investment bankers, I am told. I am a bit sceptical, because there are very few public offerings, and thus only limited demand for investment bankers with skill in these offerings.***				

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Still, the major world-class investment-banking firms all have offices in Brazil. That should ensure that investment bankers with skill in public offerings will emerge if the demand for their services emerges. Thus, this possible weakness is not likely to impede the development of Brazil's securities markets.				
11. Sophisticated securities lawyers	X	X	4	2
Brazil: *Brazil has a reasonable number of sophisticated securities lawyers. This appears to be a recent development. Most of the top securities lawyers belong to relatively new law firms. More securities lawyers will emerge when the demand for their services exists.*				
12. A stock exchange with meaningful listing standards and an active insider trading surveillance operation	X	X	5	3
Brazil: *I am told that the Sao Paolo exchange (Bovespa) does not have very strong listing rules, and relies mostly on CVM to establish rules for listed companies. However, the Sao Paolo exchange is also planning to copy the Frankfurt exchange, which created the Neuer Market for new companies, and adopted* higher *listing standards for the Neuer Market than for its existing market. This attempt may not succeed, but it is promising. The success of the Neuer Market is consistent with the importance of protecting minority investors, if one wants to develop strong securities markets. In contrast, attempts by many exchanges to offer lower listing standards to small companies have failed, in the U.S., Europe, and elsewhere. No one wants to buy these low-quality shares.*				
13. Including independent directors on company boards		X	3	2
Brazil: *At present, publicly held Brazilian companies make little use of independent directors. Also, the nominally independent directors may be not so independent in fact.*				
Liability				
14. Civil liability for insiders who violate the disclosure and self-dealing rules.	X	X	2	1
Brazil: *Insiders of major companies face very limited risk of civil sanctions, either from lawsuits by investors or civil actions brought by CVM. Partly, this is because the corporation law permits a significant range of self-dealing transactions; partly it is for other reasons, including the lack of a class action procedure.*				
15. Criminal liability for insiders who intentionally violate the disclosure and self-dealing rules	X	X	1	1
Brazil: *To date, insiders face little risk of criminal liability for self-dealing or disclosure violations. Brazil is considering making insider trading and market manipulation criminal actions. This is a positive step, but prosecution of securities crimes requires specialised prosecutors, which Brazil does not have, and is aided by sophisticated courts, which Brazil does not have.*				
16. Civil liability risk for accountants	X	X	3	2

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Brazil: *I am told that there is a theoretical basis for accountant liability, but that in practice, cases where accountants are found liable are non-existent, even in egregious cases. As a result, even big-5 accounting firms sometimes do substandard work.*				
17. Civil liability risk for investment	X		3	2
Brazil: *I am unsure of the theoretical basis for investment banker liability under Brazilian law. In any event, bankers do not face meaningful liability in practice.*				
18. Civil liability risk for independent directors who approve gross self-dealing		X	1	1
Brazil: *The first step is to have independent directors, and to give them the responsibility for approving self-dealing transactions. The next step will be to instil discipline in this process, through liability risk for independent directors who approve gross-self dealing. here, Brazil has not yet taken the first step.*				
Market Transparency				
19. Transparency of trading prices	X	X	4	3
Brazil: *The Bovespa exchange has a monopoly position, and thus currently has the power to enforce market transparency rules. Over time, it is likely that Bovespa will retain its monopoly, or suffer erosion due to competition from new electronic exchanges. Brazil will then need rules to ensure prompt disclosure of trading prices and volumes.*				
20. An enforced ban on market manipulation	X	X	3	2
Brazil: *I am not aware of a significant number of cases seeking sanctions for market manipulation. A current proposal would make market manipulation a crime. But Brazil will still lack the specialised prosecutors who would be able to bring cases involving market manipulation. Market manipulation is very difficult to prove, so specialised prosecutors are essential.*				
Self-Dealing Rules				
21. Procedural controls on self-dealing transactions (review by independent directors, noninterested shareholders, or both)		X	4	3
Brazil: *Brazil does not have sufficient procedural controls on self-dealing transactions. The proposed company law amendments, if they are adopted, will strengthen takeout rights and appraisal rights will enhance protection of minority shareholders for at least some important types of transactions. But these rights need to be extended to holders of nonvoting preferred shares (which are, in substance nonvoting common shares) to be truly effective*				
22. Accountant review of disclosure of self-dealing transactions		X	4	2

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Brazil: *Brazil does not currently have rules requiring accountants to review self-dealing transactions.*				
23. Enforced securities or other rules banning insider trading		X	3	2
Brazil: *Brazil has civil sanctions against insider trading, and a current proposal would add triple damages and criminal liability. But enforcement is minimal, and criminal enforcement requires specialised prosecutors, and will be aided by knowledgeable courts. Brazil has neither of these.*				
Other Institutions				
24. An active financial press and security analysis profession	X	X	3	2
Brazil: *I am told that Brazil has a reasonably active financial press, including speciality business newspapers in Rio and Sao Paolo, and financial analyst coverage of major companies.*				
25. A good organisation to write accounting rules	X	X	5	3
Brazil: *Brazil does not currently have such an organisation. But it is considering adopting International Accounting Standards (IAS), which will largely solve the problem of keeping the rules up to date. Brazil is also considering creating a quasi-public body to write accounting rules. This will be useful for areas, of particular concern to Brazilian companies, that are not addressed by IAS rules*				
Mean ranking:			**3.12**	**2.12**

Conclusion

Brazil has many of the institutions it needs to build strong securities markets. But there are important institutions it does not have, and the proposed company law amendments will not significantly change this situation.

Perhaps the most promising current initiative is the Bovespa plan for a small-company market with *higher* listing standards than its main market, as a way to avoid the political opposition that Bovespa would face in raising standards for its main market. If this proposal succeeds, and the government controls inflation does not make major blunders like reimposing currency controls, I believe that it is plausible for Brazil to have a world-class stock market within 10-20 years. This sounds like a long time, but in fact, this is a reasonably optimistic assessment. There are many other countries where the likely time frame to build strong securities markets will be closer to 30-50 years.

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