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## **CORPORATE GOVERNANCE IN LATIN AMERICA**

BY

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## Abstract<sup>1\*</sup>

This paper analyzes recent trends of Latin America's institutional development regarding investor protection. In spite of the underdevelopment of the region's financial markets, there is slow movement towards legal reforms intended to protect investors and make regional markets more attractive to investors; current inadequacies in the region's legal institution's generate high levels of ownership concentration, poor access to external equity financing, and narrow equity markets. The evidence in this paper, based on firm-level data for six countries, shows that, like legal protection of investors, appropriate firm-level corporate governance is linked to lower costs for capital, better valuation, performance, and dividend payments across countries. Firms can compensate for their countries' legal deficiencies by distinguishing themselves through improved corporate governance practices, thus increasing transparency and limiting potential conflict between large and minority shareholders. Firms can additionally look for capital by issuing ADRs, as they have in recent years, although this practice undermines local capital markets. In the end, firms and regulators must improve their governance structures and shareholder protections if they are to meet the improved benchmarks of developed nations brought about by Asian, European, and U.S. scandals in recent years.

**Keywords:** Corporate governance, Investor protection, Corporate valuation

**JEL Classification Codes:** G32, L22

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## **1. Introduction**

As a result of a series of corporate shocks over the last 10 years, starting with the East Asian and Russian financial crises and followed by the series of corporate governance scandals in Europe and the United States, countries in these regions have started to introduce corporate governance reforms. But the pace of reform has not been uniform across nations. For the most part, Latin America has not engaged in institutional reforms in financial markets, leaving firms in the region in a difficult position in terms of raising capital in an increasingly competitive global market.

Latin America has been surprisingly spared from a generalized wave of corporate scandals. One possible explanation is that the region's level of investor protection is adequate or has consistently improved based on the lessons drawn from governance crises elsewhere. The evidence reviewed in this paper does not support this view though. The status of shareholder protection in Latin America has somewhat improved in the last decade, but the region's low place in shareholder protection still holds. An alternative explanation for the absence of public governance scandals in the region is that the low level of protection and transparency has prevented the creation of an environment where problems may be detected or are worthwhile pursuing. The poor penetration of financial markets and the low levels of participation by individuals and institutional investors in these markets seem to suggest this is a possibility. Latin American capital markets are still among the least developed, imposing heavy burdens on firms as they try to restructure and face increasingly integrated capital and product markets. The evidence presented in the papers analyzed here suggests that even the largest capital markets in the area face the challenge of extinction.

The purpose of this paper is threefold. First, we review the recent history of Latin American capital markets and the reasons behind their poor development. We extend the empirical evidence on the institutions required to support large capital markets, presenting the situation of Latin America in contrast to the rest of the world. There is a large body of literature that has now established a causal empirical link between legal institutions and financial markets.<sup>2</sup> This paper extends some of the previous work to include a larger sample of Latin American countries of all sizes and areas within the region.<sup>3</sup> The results in presented in this paper reveal a systematic pattern of capital market underdevelopment in the region and a slow movement toward legal reform. Legal reform in the region has faced opposition because of the stubbornness

of the status quo and has been difficult to realize. It has been implemented in some countries, but, for the average nation in the region, there is still a long way to go to reach the level of effective legal protections offered by developed countries and the closest competing developing economies.

In a weak regulatory environment, firms need to adapt to an institutional framework that leaves them at a disadvantage in terms of their ability to raise finance. Companies need to work more assiduously to attract capital by providing a better bundle of protections for their investors. For this reason, within-country corporate governance characteristics may make a difference in lowering the cost of capital for firms in the region. Improving firm-level corporate governance practices is a clear need.

The second goal of this paper is therefore to provide a review and analysis of recent firm-level studies that have gathered the largest data sets on this topic in Latin America.<sup>4</sup> Until now, firm-level data on governance have been almost nonexistent. The literature reviewed in this paper fills this gap. We review main findings to show that appropriate firm-level corporate governance characteristics are linked to lower costs for capital, better performance, and better dividend payments across countries. The data gathered include data on corporate governance characteristics, ownership structures, dividend policies, and performance measures. The effort at data collection has also involved a coordinated endeavor to establish a homogeneous corporate governance questionnaire, which has been sent to firms in most of the countries examined in this paper. The results show that, on top of the countrywide legal protection of investors, higher firm-level protections and better corporate governance practices have a positive effect in valuation and performance. The evidence matches previous research on the subject in other regions of the world.<sup>5</sup> The first set of results reveals the very high levels of ownership and voting rights concentrations and monolithic governance structures in the largest samples of Latin American companies up to now. The series of new data analyzed in this paper emphasizes the importance of the specific characteristics of the investor protection regimes in several Latin American countries. By and large, the results show that those firms with better governance measures in several dimensions are granted higher valuations and thus lower costs for capital.

The third and final goal of this paper is to analyze the current threats to Latin American stock markets. If legal reform is slow to come in Latin America, functional reform may be a viable alternative for some firms and may bring improved governance. A second alternative open

to firms is to look for capital elsewhere. Cross-listing in U.S. capital markets is an alternative available to at least some Latin American firms. Issuing American depository receipts (ADRs) may be a large threat to the development of capital markets in the region, as suggested by Moel and Tufano (2002) and Karolyi (2004, 2005).<sup>6</sup> The evidence on the substantial growth of firms issuing equity in international markets in the last 10 years and the stagnant local markets in the region support this view. Finally, a third alternative is to sell out or join forces with foreign companies that do have access to lower-cost capital. Again, the large wave of foreign acquisitions in some countries in the region shows that such a movement is real. This situation presents problems for the development of local Latin American markets and for the growth of the region. Firm migration and the acquisition of Latin American corporations by cash-rich international firms that are able to raise capital at better terms pose serious threats to the growth of local markets in the region if reforms continue to be slow to come. Although firm-level efforts to improve internal governance and to access foreign sources of capital may alleviate the situation, they do not constitute a long-run sustainable strategy for private sector development. In the end, firms and regulators need actively to engage in the transformation of their governance structures and shareholder protections if they are to meet the improved benchmarks of developed nations brought about because of the Asian, European, and U.S. scandals in recent years.

The remainder of the paper is organized as follows. In the next two sections, we place the region in the context of the rest of the world and analyze country-level factors of investor protection. These sections also take a look at the last decade of corporate governance reforms across Latin America which are representative of what has happened in the region as a whole. The slow pace of reform explains part of the poor development of stock markets across Latin America, which is reviewed in the subsequent section. The section thereafter presents a summary of recent evidence on firm-level corporate governance, which represent the largest data set collected on Latin American firms so far. They portray the state of Latin American firms in terms of their ownership structures, internal organization, corporate governance mechanisms, shareholder rights, valuations, performance, and dividend payout policies. The evidence shows a potential positive role for firm-level efforts to escape a poor institutional environment. The penultimate section focuses on the large external threats to the development of capital markets in the region. The increasing financial and product market integration of the last two decades has pushed firms to look for foreign alternatives to raise capital. This observed migration may have

serious permanent effects on the growth of local markets. Finally, the last section concludes with some policy recommendations at the country and firm levels.

## **2. Investor Protections and Their Evolution**

Capital markets in Latin America are lagging behind those in the rest of the world. Figures 1, 2, and 3 show that a simple look at basic statistics on stock market development puts the region far behind not only developed countries, which may be expected, but also developing and emerging markets. With the notable exception of Chile, there has been little dynamism in the rest of the markets of the region in the last couple of decades. For the case of the larger economies in the region, such as Argentina, Brazil, and Mexico, the growth of markets has not matched that of the economy.

Although still far behind most of the world, the region seems to have shown some upward movement in terms of market capitalization as a proportion of gross domestic product (GDP) in the last 15 years (see Figure 1). But a more careful look at the numbers in Figure 2 shows that the bulk of the increase in recent times is not arising because more firms are entering the market, but rather because some large companies are capturing the market and are cross-listed in foreign exchanges (more on this below). In sharp contrast to other emerging market regions of the world such as Asia and Eastern Europe, the number of listed firms has plummeted. Since 1970, Africa and Latin America are the only regions of the world exhibiting a decline in the number of firms per million inhabitants. The incredibly low levels of trading activity portrayed in Figure 3 are also a reflection of the poor state of capital markets in the region. Today, Latin American stock exchanges are among the smallest and least active markets in the world relative to the size of the economies.

Figures 1–3 reflect some concern that capital markets in the region are not a real source of finance and have not developed at the appropriate pace to sustain business growth. There are several hypotheses that may explain the history depicted in Figures 1–3. One of the first candidates is the poor record of past economic and political stability. It is well known that there is an important relationship among macroeconomic stability, political stability, and a country's financial market development.<sup>7</sup> The 1970s and 1980s continued a history of macroeconomic instability, large government deficits, and economic imbalances that could hardly foster sufficient domestic savings to finance firms. Currency devaluations across the region also



triggered extensive capital flight and uncertainty in company investment programs. But these arguments should also mean that, when economic and political stability are reached, one would expect better conditions mapping into bigger markets. This is not the case of the average country in the region, however. The relatively more stable macroeconomic environment and transition to democracy in many countries have not materialized into a consolidation of capital markets as a serious source of financing. Many other countries and regions around the world have undergone experiences similar to those in the average Latin American country. Yet, the capital markets in these nations have performed much more effectively, as Figures 1–3 illustrate.

The persistently low penetration of Latin American capital markets calls for more analysis that digs into structural explanations. In the rest of the section, we look at the fundamentals of investor protection in a global context to try to understand part of Latin America's lackluster capital market performance. One explanation is provided by an examination of the quality of financial market institutions and a comparison with similar institutions in the rest of the world. Such a comparative approach, rooted in agency theory, holds that better investor protection should translate into a lower cost for capital and more access to finance.<sup>8</sup>

To understand the tenets and evolution of the legal approach to finance, we need to depart from the basic premise that the separation between ownership and control may have a large effect on the size of capital markets as we depart from Modigliani-Miller assumptions.<sup>9</sup> In a simple Modigliani-Miller framework, the size of capital markets is determined only by the cash flows that accrue to investors. Therefore, roughly speaking, the size of capital markets should be proportional to gross national product (GNP). To explain the large discrepancies in the size of financial markets across countries with similar GNPs, one needs to recognize that securities are more than the cash flows they represent, since they entitle investors to exercise certain rights. Shares entitle investors not only to dividend payments, but also to exercise control over management through the voting process. To take an extreme view, outside equity would have no value if shareholders did not have control rights to force managers to pay out dividends. In the same vein, creditors would be unwilling to lend money at any interest rate if their control rights did not allow them to punish debtors who default on financial obligations.

Both financiers and management would benefit from the elimination of the agency conflict if they were able to write a complete contract that specified what the manager should do

with the funds and how he would give them back to investors in all states of the world and under all conditions. Of course, such a complete contract cannot be implemented in practice, making it necessary for management to have some level of discretion.<sup>10</sup> Management discretion, although a cost-effective way of dealing with the separation of ownership and control, may, unfortunately, be used to expropriate financiers through outright expropriation, transfer pricing, or asset stripping.

The agency model might, in principle, explain why some countries have much larger capital markets than others, since it is apparent that countries differ enormously in the extent to which they afford legal protection to investors. Not only does a shareholder in Peru, for example, have a different bundle of rights from one in the United States, but also his recourse to redress is likely to be significantly weaker. The agency model predicts larger capital markets in countries where agency costs are reined in by the law and the institutions built to support their enforcement.

### ***2.1. Shareholder Rights in the 1990s***

La Porta et al. (1998) systematically assess the rights of investors, as well as the quality of rights enforcement in 49 countries. La Porta et al. (1997, 1998) and La Porta, López-de-Silanes, and Shleifer (1999) relate legal institutions to the size and breadth of external capital markets, as well as to corporate ownership concentration around the world. There are numerous differences among company laws in different countries. But for the purpose of understanding the status of minority investors that are facing the decision to invest in a firm, one might focus on basic rules that scholars believe to be essential to corporate governance. Annex 1 provides a detailed description of all the variables used in this section; Table 1 presents the evidence on shareholder rights for the cross-section of 49 countries included in the original La Porta et al. (1998) paper and for the expanded set of 59 countries included in López-de-Silanes (2003), which updates and expands the Latin American countries included in the original La Porta et al. work. Naturally, laws in different countries are typically not written from scratch, but rather transplanted—voluntarily or coincidentally—from a few legal families or traditions. In general, *commercial* laws come from two broad traditions: common law and civil law. Table 1 includes all available

Latin American countries in each case, as well as the means for the other legal families in the world, namely, common law and the rest of the civil law families.<sup>11</sup>

Shareholders have residual rights over the cash flows of the firm. The right to vote is the shareholders' main source of power. This right to vote in the general meeting to elect directors and make major corporate decisions guarantees shareholders that management will channel the firm's cash flows to shareholders through the payment of dividends rather than divert the funds to pay themselves higher compensation, undertake poor acquisitions, or take other measures not in the interest of shareholders. Therefore, voting rights and the rights that support voting mechanisms are the defining features of equity. Institutional investors and those associations that sell such investors analyses of corporate practices around the world pay close attention to these measures because the measures constitute some of the main tools available to these entities for monitoring firms and ensuring that returns flow properly toward investors.

Shareholder protection in common law countries is significantly better than it is in French civil law countries. The data in both panels of Table 1 show that, while the incidence of cumulative voting for directors and preemptive rights are not statistically different across English and French legal origins, the remaining four measures showed marked differences in the 1990s. If we focus on the data for 1999, for example, common law countries more frequently allow shareholders to exercise their vote by mail than do French-origin countries (40 percent versus 3 percent). No common law country blocks shares before shareholders' meetings, while 59 percent of French civil law countries do. On average, 9 percent of share capital is sufficient to call an extraordinary shareholders meeting in common law countries, whereas 15 percent of share capital is required in French civil law nations. Finally, 95 percent of common law countries have an oppressed minority mechanism in place, while only 28 percent of French-origin countries do. The differences between English- and French-origin countries are captured in the anti-director's index, which has an average of 4.00 for common law countries, but only 2.07 for French civil law nations (a t-statistic of 6.09).

Latin America scores somewhat higher than the average of all French-origin countries in many shareholder rights. Latin America does have a higher incidence of one share–one vote (59 percent versus 41 percent) and has a higher incidence of proportional representation (41 percent versus 31 percent). Latin America is also a bit less likely to block shares (35 percent versus 41 percent), is not statistically different in terms of granting preemptive rights (53 percent versus 52

percent), and has only a slightly higher incidence of oppressed minority remedies (35 percent versus 28 percent). On the other hand, Latin America never allows proxy by mail (versus 3 percent for all French-origin) and requires a higher fraction of the share capital to call for an extraordinary shareholders meeting (18 percent versus 15 percent). With the exception of the one share–one vote rule, these differences are not statistically significant when taken in isolation. Although not statistically significant, the differences add up to marginally better shareholder rights in Latin America than in all French civil origin countries when rights are aggregated in the anti-director index (2.06 versus 2.07). However, Latin America’s anti-director rights index is statistically significantly at a lower level than the index for common law countries.

German civil law countries share the lack of protection of shareholder rights with the French-origin countries. Although German-origin countries have a significantly higher incidence of oppressed minority mechanisms, they block shares more often than French countries do. The average anti-directors scores for the German and French families are very similar (2.33 versus 2.07). Finally, Scandinavian-origin countries, although clearly inferior to common law countries in shareholder protection, are the best within the civil law tradition. The average Scandinavian anti-directors rights score is 3. In short, relative to the rest of the world, common law countries have the package of laws most protective of shareholders.

Legal rules are only one element of investor protection; the enforcement of these rules may be equally or even more important. If good laws are not enforced, they cannot be effective. Likewise, investors may enjoy high levels of protection despite bad laws if an efficient judiciary system is able to redress expropriations by management. In this way, strong legal enforcement may serve as a substitute for weak rules. Table 2 presents several proxies for the quality of enforcement of laws in different countries. These measures are collected by private credit-risk agencies for the use of foreign investors interested in doing business in the respective countries (e.g., Business International Corporation, Political Risk Services). We use five measures: efficiency of the judicial system, rule of law, corruption, risk of expropriation; and risk of contract repudiation. The first two of these proxies pertain to law enforcement, while the last three capture the government’s general attitude toward business. In addition to these measures, we also use the data collected in Djankov et al. (2003) to provide an objective rather than subjective measure of efficiency of the legal system. This measure creates an index of restrictions or complexities in the resolution of disputes through courts. Finally, we also have

another objective measure of enforcement deriving from collected data on the quality of accounting standards of publicly traded firms in different countries. Accounting is central to corporate governance; it may be difficult to assess management performance without reliable accounting standards. More broadly, cash flows may be very difficult to verify in countries with poor accounting standards; consequently, the menu of financial contracts available to investors may be substantially narrower in such countries. The index of accounting standards in Table 2 is provided by the Center for International Financial Analysis and Research based on examination of company reports of firms in each country. It is available for 41 of the 59 countries in our sample.

We may begin the discussion of these data by focusing on the Latin American average. Compared with the English-origin average, Latin America has very weak legal institutions and accounting standards. A corrupt or inefficient legal system, coupled with poor disclosure standards, might render legal rules ineffective.

While the Latin American average of most enforcement variables is below the French-origin average, it turns out that the French civil law family shares Latin America's weak legal-enforcement mechanisms. The French family has the weakest quality of legal enforcement and accounting standards. Scandinavian countries have the strongest enforcement mechanisms, and German civil law and common law countries are close behind. Common law countries, although behind Scandinavian nations, are still ahead of the French civil law countries. Note that rule of law is the only measure where differences in means between common law and French legal origin are not statistically significant. An inspection of Table 2 suggests that, for the enforcement measures, the level of per capita income may have a more important confounding effect than it does for the laws themselves. Regression analysis shows that, in most measures of enforcement, richer countries have a higher quality of enforcement (La Porta et al. 1998). Nonetheless, even when one controls for per capita income, the legal family matters for the quality of enforcement and the accounting standards. The Latin American subgroup of French civil law is consistently associated with lower enforcement across the board, even controlling for per capita income.

These results do not support the conclusion that the quality of law enforcement substitutes or compensates for the quality of laws. An investor in Latin America—and, more generally, in a French civil law country—is poorly protected by both the laws and the system that enforces them. The converse is true for an investor in a common law country, on average.

Poor enforcement and accounting standards aggravate, rather than cure the difficulties faced by investors in French civil law countries. The weak scores obtained by Latin America in shareholder and creditor rights may actually understate the severity of the corporate governance problem in the region.

### ***2.3. The Evolution of Shareholder Protection to 2005***

The past decade has been plagued by scandals of conflicts of interest and a political agenda that has prominently displayed corporate governance across countries. The initial indicators presented in panel A of Table 1 were, in fact, the first available measurements of shareholder protection across countries. However, almost a decade has passed since the initial calculation of these indicators. The wave of corporate governance scandals during the East Asian crisis, followed by Russia's crisis and the poor corporate governance practices of firms in Europe and the United States have propelled investor protection to the headlines of newspapers and the top of the policy agenda in many countries. Therefore, to obtain a complete picture of what has happened, it is important to analyze the recent evolution of investor protection in Latin America.

In the rest of this section, we will review the most recent evidence from various sources of data that paint a fuller picture of the state of shareholder protection in Latin America and other regions of the world. We will also analyze several of the reforms that have been undertaken in the core Latin American countries analyzed in this paper to try to catch up with an increasingly upward moving target in corporate governance best practice.

Table 3 summarizes the main efforts undertaken by the six countries analyzed in this paper in terms of corporate law and securities law reforms since 1950, for the case of corporate law, and since 1975, for the case of securities laws. The table reveals a bipolar pattern. It seems that securities laws, partly as a result of the consolidation of stock markets over the last 30 years across the region, have been the source of changes. In certain cases, such as Mexico, countries have even reissued new laws, sometimes after a series of gradual, partial changes. Basically, all countries in the sample have been active on this front.

On the other hand, Table 3 also shows that no corporate law reform has taken place in half of the countries in the sample for several decades. No country has issued any new corporate law in almost 30 years, while only Brazil, Chile, and Colombia have passed partial reforms of their corporate regulations. The table suggests that legal reforms through congress have been

slow to come and that countries in the region have opted for the possibly easier route of changing securities laws, which possibly requires less political conflict with the legislature. The danger of this strategy, assuming it succeeded in passing substantial reform, is that the dichotomous paths are only likely to hurt the small and medium firms in the region because they cannot access capital markets.

To analyze the content of the changes brought about by the reforms that have taken place in the region, one must look at the actual shareholder rights embedded in the new rules. The first natural candidate for analysis is shareholder rights, because these have recently been recalculated for 2005 in Djankov et al. (2006). The numbers are shown in Table 4. The sample included here has increased from 49 to 72 countries, representing over 99 percent of the world's market capitalization. The revised index relies on the same basic dimension of corporate law as the previous index but defines the variables with more precision and eliminates enabling clauses from actual shareholder protections. It also focuses on the impact of law on publicly traded firms when there are different regulations that apply to publicly traded versus non-publicly traded firms.

Table 4 shows that the level of investor protection in the average country in the world has increased from 3 to 3.4 points on the anti-director's scale. This fact seems to be consistent with the view that corporate governance scandals may have triggered some reforms that have impacted this rough measure of investor protection. Nonetheless, the differences between the level of shareholder protections between common and civil law countries remain virtually intact. For the case of Latin American countries, the revised index shows an aggregate score of 2.54, virtually identical to the score in 1995. Although the number of countries is different in both panels of Table 1 and in Table 4, the averages across the region are virtually identical if we average the common countries in the tables. These numbers corroborate what Table 3 has previewed: there has been no major revamping of corporate law in the region, and, where partial reforms have taken place, they have not significantly changed the environment of investor protection.<sup>12</sup>

A comparison across countries within Table 4 also shows that the relative situation of the region has not materially changed. As in Table 1, common law countries and the German and Scandinavian civil law families show higher indicators of shareholder protection than do the countries in Latin America. Perhaps the most surprising fact comes from the comparison

between Latin American countries and the rest of the countries that belong to the French civil law family. While the average French civil law nation outside Latin America has improved its score from 2.00 to 2.91, the countries in Latin America have simply stagnated on this front.

It is possible that the political realities of most Latin American nations have made it difficult for governments to pass swift reforms in the area of corporate law. For this reason and, again, based on the partial picture of reform dates drawn from Table 3, dates, we need to look at securities laws to complement the picture. Securities laws may complement corporate law and tort law and provide additional incentives to keep market issuers from taking advantage of investors, thus reducing the cost of contracting and resolving disputes and encouraging the search for external financing. Securities laws may bring benefits to the enforcement of good conduct through the provision and regulation of market mechanisms and the litigation of private contracts.

As Table 3 shows, securities regulation has been the area in which some activity in investor protection reform has recently taken place. Several reforms in the region have improved transparency and shareholder rights for publicly traded firms. Chile was the first country to revamp its securities law (in the early 1980s), followed by most of the other countries only in the 1990s. The details of the reforms in this area are outlined in Chong and López-de-Silanes (2007).

Securities laws aim at regulating the behavior of market participants and provide incentives for issuers not to abuse their information advantages over simple investors. As La Porta, López-de-Silanes and Shleifer (2006) detail, these objectives may be achieved by empowering the supervisor of the market or by improving disclosures and reinforcing liability standards that facilitate private enforcement against those that take advantage of investors.

To establish specific investor protections through securities laws, it is useful to focus on the promoter problem. The promoter problem has been the focus of many of the analyses of securities regulations because it is a problem that may be full of agency conflicts between prospective investors in an initial public offering (IPO) and the promoter, or issuer, who offers shares for sale. La Porta, López-de-Silanes, and Shleifer (2006) collect data on the regulation of IPOs covering three groups of measures in the context of the new issuance of securities in the market. Table 5 shows these measures for all countries in the sample of La Porta, López-de-Silanes and Shleifer on 49 nations and for the average country in the various different legal families described above.<sup>13</sup> The first two columns of the Table show an index of compulsory



disclosures of potential conflicts of interests around the IPO and an index of the liability standards in cases against issuers and directors, distributors, and accountants involved in the offering. The last column reports an index of the characteristics and investigative and sanction powers of the regulator or public enforcer. The exact definitions of the variables can be found in Annex 1. All indicators are standardized to fall between zero and 1, whereby higher numbers mean higher standards. The cutoff date for the regulations measured here is 2003, which means that reforms recent years are not reflected among the indicators.

In the area of the disclosure of potential conflicts of interest on this issue, Latin America as a whole ranks last, even behind the rest of the French civil law nations. The average country in the region has few regulations requiring the disclosure of the terms of material contracts outside the ordinary course of business, disclosures of the transactions in which related parties have an interest, and disclosures coming from shareholders themselves. Argentina, Chile, and Mexico manage to approach the world mean in disclosures, but other countries in the region lag far behind. The first column of Table 5 shows that disclosure strength is far superior in other nations of the civil legal family, as well as in most countries of common law origin.

Unfortunately, the picture in terms of liability standards for participants in the IPO is not any better. With the rare exception of Peru, the rest of the Latin American nations in Table 5 exhibit some of the highest levels of burden of proof in the world. The liability standards of the issuer, its directors, and the underwriter are low, and investors find it virtually impossible to recover losses from any of these parties due to the extremely difficult requirement of proof at the level of intent or gross negligence. This situation contrasts sharply with that in other developed countries, such as the United States, where investors need to prove only that the prospectus contained misleading information. Similarly, the burden of proof is much lower in other developing nations, such as the Republic of Korea or Malaysia, where investors are only required to show that they have relied on the prospectus or that their losses were caused by the misleading information.

The dark picture portrayed in the indicators of the first two columns in Table 5 may make the reader wonder if the wave of recent reforms in the area of securities laws in Latin American countries has really amounted to a substantial initiative with genuine effects. Answering this question involves looking at the other two areas where most of the reforms in the region seem to

have focused their energy: the powers of market regulators and laws pertaining to self-dealing (transactions with potential conflicts of interest) or related party transactions.

Latin America does fare better in the area of public enforcement than in the areas of disclosure and private enforcement via liability standards. The third column of Table 5 shows that the average capital market regulator in Latin America has as many rule-making powers and abilities to impose sanctions as the average regulator in other nations in the world. There are, in fact, no statistically significant differences between Latin America and the rest of the groups shown in column 3 of Table 5 (the statistics are not shown).

In terms of the regulation of self-dealing, some of the main changes in the recent wave of reforms of securities laws have been motivated by the scandals in developed countries and the acute emphasis that policy makers around the world have placed on improving what is now commonly known as corporate governance. Although securities laws and corporate law seem to have different targets and purposes, the reality is that these two sets of regulations interact in many areas. Some areas of corporate law apply to privately and publicly held firms. For this reason and with the aim of painting the most comprehensive view of investor protection in Latin America, one must adopt an approach that allows a focus on self-dealing regulation because this is the main problem area in corporate governance, and it will allow us to create a vision of all regulations and their interactions. The corporate governance scandals that have taken place from East Asia to Italy, Russia, and the United States have all involved some kind of self-dealing transaction such as excessive executive compensation or loans, transfer pricing, targeted repurchases, corporate opportunities, and the purchase and sale of assets far from arm's-length terms.

The regulation of self-dealing involves corporate and securities laws, as well as a series of other regulations that even include civil procedure (that is, rules of evidence, and so on). As in the case of the offering of securities to investors through the market, self-dealing transactions may be monitored using public and private enforcement mechanisms. Public enforcement on this issue has been on the rise, as evidenced by the recent U.S. Sarbanes-Oxley Act, which includes higher fines and prison terms for those found guilty. We have also seen an increase in measures that facilitate private enforcement, as several countries have improved their corporate disclosure standards and approval procedures, and a few have also tried to facilitate private litigation aimed at redressing unfair transactions.

Table 6 presents the results of the analysis of the regulation of self-dealing. The data are based on the recent work by Djankov et al. (2006). The table attempts to summarize the set of measures available to try to stop or to obtain redress from a classic transaction with potential conflicts of interest that is characterized by the fact that the controlling shareholder is on both sides of the deal, in this case, the purchase of an asset by a corporation. As in Table 5, there are measures that speak of facilitating private enforcement before or after the transaction takes place and providing powers to the regulator to act. The Table shows the numbers for all Latin American countries available in the 72-nation study and the mean scores for legal families around the world.

The first column shows the data for ex-ante measures against self-dealing. These measures keep track of approval requirements that need to be fulfilled and mandatory disclosures that need to take place before the transaction occurs. These disclosures may come from the acquiring company or the conflicted party. The index also takes into consideration the availability of an independent review of the transaction before it actually happens. The column reveals that the average Latin American country lacks the “bells and whistles” that are found in a transparent system for the control of this type of transaction. Latin America and other French civil law countries are far behind the average common law nation, which makes disclosure and arm’s-length approval a priority in attacking this potential problem.

The second column of Table 6 tries to summarize the situation that shareholders would face if they attempt to seek redress once the self-dealing transaction has taken place. Shareholders may use disclosures that are required after the transaction, such as in the annual report, and all other legal means to prove wrongdoing, find evidence, and seek compensation. The score of Latin America shows that, on average, shareholders would have a hard time obtaining standing to sue, access evidence, and seek redress relative to investors in the average common law country and even in other civil law families. Although this is an area where some Latin American nations have recently undertaken reforms, investors are far from possessing the power to act if they fear expropriation through this kind of conflicted transaction.

Overall, the lack of ex-ante bells and whistles, lower-than-average ex-post disclosure requirements, and the difficulties in seeking redress in Latin America are responsible for the low total score in the regulation of self-dealing. Some Latin American countries score among the lowest 10 countries in the world. Contrast this with the average nation in the common law

family, which includes high- and low-income countries. In the median common law country, related-party transactions are reviewed by independent financial experts and approved by disinterested shareholders. Extensive disclosures take place both before and after a transaction is approved. Finally, establishing liability, although costly, is relatively easier than in the average Latin American nation because of lower ownership requirements, a lower threshold of proof, and substantial access to evidence. The situation in the United Kingdom and the United States, the countries with the largest immigration of firms in the form of depository receipts, is also much better.

The last column of Table 6 shows an aggregate index of public enforcement mechanisms that group the penalties imposed by the public regulator on those who are found liable in the area of self-dealing. Half of the countries in Latin America impose fines on those directors found liable, but not on the controlling shareholder. The average country in the region also imposes prison terms above 10 years for such crimes. The penalties are among the highest in the world, but there is virtually no record of actual application of these penalties to a case such as the self-dealing transaction in the study. The risk is that, as in many other countries, the existing penalties are hardly a deterrent when it becomes virtually impossible to prove wrongdoing. Additionally, the region may be facing serious problems in the enforcement of such penalties by the regulator. Despite the recent progress in securities regulation in some countries in the region, the data in Table 6 suggest that there is a great deal of room for improvement of shareholder protections.

A skeptic may argue that Latin American countries are simply different from common law countries and that a high level of shareholder protection against self-dealing and abuse by the promoters of securities is simply unattainable in the region. The answer to such claims is Chile, which belongs to the French civil law family, like the rest of Latin America, and shares a lot of the geographic, political, and economic characteristics of other countries in the region. The various scores for shareholder protection across Tables 1 through 6 also reveal the strength of corporate governance in Chile relative to the region. Of course, this is only one observation, but it goes to the heart of the critique of the infeasibility of substantial reform within the region.

### **3. Access to External Finance**

The ultimate question is whether countries with poor investor protections actually do suffer. If laws and their enforcement matter, then countries that offer entrepreneurs better terms of external finance would have both higher-valued and broader capital markets. We also predict that countries that offer entrepreneurs better terms would have widely held corporations. Consequently, this section compares external finance and ownership concentration across countries as a function of the origin of their laws, the quality of legal investor protections, and the quality of law enforcement.

There are at least two reasons why legal institutions may have no effect on the pattern of the external financing of firms. First, laws may not be necessary to support external financing if, for example, companies deliver on their promises not because they are forced to do so, but because they want to build a good reputation to facilitate their access to capital markets.<sup>14</sup> Reputations unravel if there is ever a time when the gains from cheating exceed the value of keeping external financing open, since investors, through backward induction, would never extend financing to such a firm to begin with.

Second, poor laws and their enforcement may have no real consequences if firms may easily opt out of the laws of their legal jurisdictions. Easterbrook and Fischel (1991) are skeptical that legal rules are binding in most instances, since entrepreneurs may offer better investor rights, when it is optimal to do so, through corporate charters that effectively serve as contracts between entrepreneurs and investors. In practice, however, opting out may be costly both for firms that need to write nonstandard contracts and for investors who need to study them. In addition, courts may be unwilling or unable to enforce nonstandard contracts, further limiting the scope for opting out.

Alternatively, if legal institutions matter, ownership concentration should be higher in countries with poor investor protection than in countries with strong protections for investors. This is so for at least two reasons. First, agency problems may call for large shareholders to monitor managers and thus prevent or minimize expropriation. Second, minority shareholders may be unwilling to pay high prices for securities in countries with weak legal protections. At the same time, entrepreneurs are going to be more reluctant to offer shares at discounted prices, thus resulting in higher ownership concentration, as well as smaller and narrower markets for external equity.<sup>15</sup>

Ultimately, the question of whether legal institutions matter is fundamentally empirical. If opting out were cheap and simple, the patterns of ownership and external financing among firms would not be affected by differences in legal institutions across countries.<sup>16</sup> Accordingly, in this section, we examine two types of evidence regarding the influence of legal institutions on external finance: ownership concentration and the size and breadth of capital markets. Table 7 and Figure 4 below summarize the results that are obtained from previous studies and from the firm-level analysis presented in this paper.

### ***3.1. The Size and Breadth of Capital Markets***

There are several now-standard measures of external equity financing and stock market development.<sup>17</sup> Table 7 summarizes the results of the three widely used measures of equity finance. The first measure is the ratio of equity finance to GNP between 2000 and 2005. The procedure we follow may overestimate the level of external financing in poor protection countries, since ownership concentration is likely to be higher in these markets. A conceptually better measure involves looking at the corrected measure of true equity financing that considers ownership concentration levels.<sup>18</sup> The remaining two measures of external equity financing capture market breadth. The first is the number of domestic firms listed in the stock exchange of each country relative to the country's population. The second is the value of IPOs of shares as a proportion of the size of the economy between 2000 and 2005. We look at both the stock and flow of new companies obtaining equity financing since the development of financial markets has accelerated greatly in the last decade, and, hence, the IPO data provide a more recent picture of external equity financing.

Several interesting patterns emerge from the examination of our proxies for external equity financing in Table 7. First, access to external equity financing is most limited in French civil law countries. Specifically, the ratio of total capital and external capital to GNP and the ratio of domestic firms to population are roughly two-thirds of the world mean. The ratio of domestic quoted companies to population and the IPO-GDP ratio are also roughly two-thirds of the world mean. Equity markets are particularly narrow in Latin America. In fact, Latin American countries are well below the rest of the French civil law countries and explain a large portion of the low ratios of this legal family. For Latin American countries, the ratio of the number of firms to population is roughly one-fourth of the world mean, whereas the ratio of the

number of IPOs to population is almost 10 times smaller than the world mean. The first column shows that the size of the stock market in the average Latin American country is less than half the world mean. If we compare the Latin American numbers to the numbers of the average common law country, the results are even more surprising. The median country in the region has capital markets that are a third of those of the median common law nation.

Table 7 shows results without controlling for other country characteristics. As argued above, it is possible that macroeconomic, geographic, or political conditions do impact the size and breadth of capital markets. In order to take these factors into consideration, Tables 8 through 13 present regressions of the external financing measures on investor protection, controlling for country-specific characteristics. Tables 8 and 10 use data for the mid-1990s from the sample that includes a total of 19 Latin American countries. Tables 9, 11, 12, and 13 use more recent data on capital markets and include the samples used in La Porta, López-de-Silanes and Shleifer (2006) and Djankov et al. (2006). The latter tables have the advantage of using more recent data and sometimes a larger sample of countries, but they do not include as many countries from Latin America as the first two regression tables. Another reason for presenting these two sets of regressions is to illustrate that results are robust to alternative samples, time periods, and indicators of shareholder protections.

In all specifications, we regress our measures of capital markets on macroeconomic variables and law enforcement. All regressions include economy-wide controls. We control for different sets of measures to show robustness. The first of these controls is the growth rate of GDP on the theory that growth affects valuation, which, in turn, may affect ownership patterns because entrepreneurs are more willing to issue at attractive prices. We also control for the logarithm of total GNP on the theory that the creation of capital markets may be an activity subject to increasing returns to scale. If this theory is true, we should observe that larger economies have larger firms, which might therefore show lower ownership concentration. In some tables, we present the log of GNP per capita as an alternative economy-wide control. All regressions also control for different indicators of law enforcement across the tables. Tables 8 and 10 use the average index of the rule of law for the past 20 years as a measure of the quality of enforcement. These results are representative of other specifications with alternative subjective measures of enforcement used in the literature. In Tables 9, 11, 12, and 13, we use an objective measure of court efficiency found in Djankov et al. (2003). This variable measures the

average length of the civil procedures needed for the same simple claim of collecting a bounced check through the court in each country.

We organize the discussion of the results across tables around five main areas. First, all indicators of economic conditions (that is, the growth of GDP, the size of the economy, and GDP per capita) have the signs predicted by theory, but only GDP per capita consistently predicts larger capital markets with statistical significance. Second, enforcement measures, namely, the rule of law and the log of the number of days to collect on a bounced check through the courts, have a large and significant impact on all measures of development of capital markets. A move from the world mean to an almost perfect enforcement score or the lowest delay in the collection of a claim is associated with an increase of, respectively, close to 15 and 21 percentage points in the ratio of external market capitalization to GNP, an additional 11 to 12 firms per million population, and an additional 1.2 IPO to GDP ratio. All results are statistically significant.

The fourth set of results is derived from an examination of Table 8 and Table 9, which use the legal origin family of each country as a proxy for investor protection. The previous tables suggest that there are systematic differences across legal families. These regressions show that those differences still persist once we control for other country characteristics. Relative to common law countries, all civil law families tend to have smaller capital markets, but statistical significance is not reached in a few specifications for the German and Scandinavian civil law groups. The differences between common law and Scandinavian countries are, in fact, rarely statistically significant.<sup>19</sup> German and Scandinavian legal origin countries are also associated with smaller and narrower stock markets than are the English origin countries, but the effects are not as pronounced as they are with French legal origin.

For the purposes of making more specific statements about Latin America, we have split the French civil law countries into those that are located in Latin America and those that are not. The analysis of the results in Table 8 and Table 9 shows that, compared to common law countries, both groups of French civil law countries show smaller ratios of external equity to GNP and of total market capitalization to GDP. But the Latin American countries suffer the most from shallow markets, which translate into few listed firms and small IPO activity. Relative to the average common law country in the mid-1990s, Latin American countries exhibited a ratio of external equity to GDP that was lower by 30 percentage points, 19 fewer publicly traded firms per million people, and a ratio of IPO to million people that was 1.2 lower (see Table 8). As



Table 9 shows, Latin American–French civil law countries still have significantly smaller capital markets today than the average common law nation, with a ratio of total market capitalization to GDP that is 50 percentage points lower, 30 fewer publicly traded firms per million people, and a ratio of IPO to GDP that is 3.7 percentage points lower. Simply put, the situation has not improved in the last 10 years.

The fifth set of results refers to the impact of the various measures of shareholder protections presented in Table 1 through Table 6. The results for all measures of shareholder protections are found in Table 10 and Table 11. The numbers are easy to summarize. All shareholder protection measures have a large impact on equity financing in both statistical and economical terms whether in the mid-1990s or in the more recent data for the period since 2000. To illustrate the magnitude of this impact, one might usefully consider that an increase by two standard deviations, equivalent to a jump from the level of protection found in a country such as Venezuela to the mean of common law countries, would be reflected in an increase by 33 percentage points in the ratio of external market capitalization to GNP, an additional 16 publicly traded firms per million population, and 1.2 additional IPOs per million population in the mid-1990s (see Table 10). A similar jump by two standard deviations in the more recent data on anti-directors rights recalculated for 2005 would be reflected in an increase by 23 percentage points in the ratio of total market capitalization to GNP (see Table 11). The measures of IPO and anti–self-dealing regulation also have a large impact on the size of capital markets: an increase by two standard deviations in disclosure requirements and liability standards for the initiation of an IPO would translate into an increase in the ratio of the stock market to GNP of 49 and 37 percentage points, respectively. A similar jump in the anti–self-dealing index is reflected in an increase by 39 percentage points, or 65 percent of the mean stock market to GNP ratio (see Table 11). Finally, public enforcement variables have a smaller or insignificant impact on the development of capital markets and a large impact on equity financing and are statistically significant most everywhere.

Table 12 takes another look at the contribution of law and enforcement to the development of capital markets by controlling for legal origins and also the various indicators of shareholder protection. It represents an attempt to disassociate the link that the literature has documented between various legal origins and other negative characteristics. In Table 12, we control for legal origin and then interpret the results in terms of the various indicators of

shareholder protection as additional components that arise from the specific measures of the laws of investor protection captured by each index. The results in the table echo those of the previous tables: French civil law countries, whether Latin American or not, have less developed markets. But those countries that have higher levels of shareholder protection within these areas are able partly to escape their origin. In all regressions, the individual measures of shareholder protection are positive and significant.

One may argue that the different indicators of investor protection that are presented are closely related, and their impact is therefore not likely to be independent. For this reason, in Table 13 we use all of our variables in the measurement of shareholder protection to construct two aggregate indexes that aim to capture the effectiveness of private measures and public measures of corporate governance. We use principal components analysis to construct these two indexes. The results suggest that the measures of the private enforcement of investor protection enhance external finance, while measures of public enforcement seem to deter it. An increase of two standard deviations in our private enforcement index leads to an increase of about 43 to 51 percentage points in the ratio of stock market capitalization to GNP. This evidence supports the idea that, if reform is to take place in the region, the measures that facilitate disclosure and give investors the power to act have a more direct effect on the development of local capital markets.

Overall, the results of these five tables show that enforcement and shareholder rights have a large impact on the availability of external equity financing across countries. The regressions also confirm earlier results in the literature showing that the legal institutions of French and German civil law countries reduce the size and breadth of stock markets. Finally, the econometric estimates corroborate the hypothesis that part of the large underdevelopment of Latin American capital markets is due to the poor level of shareholder protection embedded in various laws and the weak enforcement in the region.

### ***3.2. Ownership Concentration***

The image of the public corporation as a firm owned by dispersed shareholders, while control is concentrated in the hands of management, has been shown to be the exception rather than the rule in most countries around the world.<sup>20</sup> For the case of Latin America, the available empirical evidence is scant because of the difficulties in obtaining complete, reliable data on the structure of ownership beyond the largest companies. In this paper we review the evidence presented on a

set of recent studies for Latin America, which comprise the largest firm-level datasets for each of the countries analyzed. The studies reviewed in this paper fill the gap in the literature by providing a picture of the large ownership concentration in the region.

Information on ownership concentration represents a simple, alternative way to understand whether capital markets are broad and whether firms are able to place their stocks in the hands of investors. It is one of the most difficult types of statistics to obtain because ownership tends to be kept secret or disguised in many places. Latin America is, in fact, one of the regions in the world where this problem is exacerbated. One of the main contributions of the studies reviewed in this paper is to provide detailed information on levels of ownership concentration and deviations in cash flow and control rights among the largest samples of firms being studied in Latin America today. The authors have used this information to examine in depth the ownership structures of firms and reveal, beneath the various layers of ownership, the “ultimate” owners of publicly traded firms. The methodology followed by the authors is similar to that applied in La Porta, López-de-Silanes, and Shleifer (1999). In many cases, the owners of firms are institutions or other corporations; thus, to discover the people who ultimately control the companies, we need to look for the owners of these firms and institutions. This is not an easy process; it requires a lot of information that was unavailable until now.

Figure 4 summarizes the measures of ownership concentration found in the abovementioned papers. The red columns show the calculated concentration of the cash flow rights of the controlling groups in six countries on which data are available. The figure shows that, on average, the controlling group is sitting on 55 to 60 percent of the cash flow rights over the companies. This can hardly be said to help in the diversification of risk by the controlling group. But, more importantly, the figure also shows that minorities are barely present in the average corporation in Latin America.

As confirmation for these findings, which include all firms in the regional sample, we show the blue bars in Figure 4. These bars are based on the calculations in La Porta et al. (1998), who assembled data on the 10 largest publicly traded, nonfinancial private domestic firms in each country and measured ownership concentration as the median percentage share owned by the three largest shareholders in each of the 10 firms. The results echo the detailed comprehensive analysis of the papers analyzed here: ownership is highly concentrated even in the largest firms in the sample. The only country in which large firms appear to be an exception

is Chile. In the case of Chile, ownership concentration is almost half of that of the mean firm listed in the Santiago market. As other figures in the paper show, part of the difference between Chile and the rest of Latin America lies in the higher levels of protection offered to investors in Chile. This is documented in the previous tables.

The separation of ownership and control in Latin American corporations is accomplished through the use of the two classic mechanisms: nonvoting shares and pyramids. In many countries, the law authorizes firms to issue stock that has no voting powers or only limited voting powers. Where this is the case, there is a distortion in the one share–one vote rule so that more powers are effectively given to those who have fuller voting rights. Pyramids are another such distortion of the one share–one vote principle. A pyramid is defined as those publicly traded firms where at least one other publicly traded firm is between the firm and the ultimate owner. The use of multiple layers of ownership in the pyramid allows insiders in control at the top also to control the resources of all the other firms in the pyramid even though their actual ownership in the firms at the bottom of the pyramid may be small. Several of the papers reviewed here document the widespread use of pyramids in Latin America. Pyramids are a common approach in countries such as Brazil (to a lesser extent), Chile, and Mexico.

Two other mechanisms to separate ownership and control appear to be prevalent in Latin America: cross-shareholding, whereby firms own each other's shares, and multiple or nonvoting share mechanisms. As in the case of a pyramid, the existence of shares with different voting rights facilitates control over decision-making by insiders with preferential voting rights. The nonvoting share mechanism is most common in Brazil, but it may also be found in other countries in the region and is widely used by firms that cross-list. All countries in the region, with the possible exception of Colombia, show significant frequency in the use of mechanisms to separate ownership and control.

Figure 5 shows that the value of the control block premiums for Latin American corporations is high. The data on block premiums in Dyck and Zingales (2004) indicate that Brazil, Mexico, and Venezuela have the highest block premiums in Latin America. Some of these countries have, in fact, show some of the highest numbers in the world. The value of the block premiums for firms in Argentina, Chile, and Colombia is lower. Several of these countries actually have better investor protections according to the measures outlined in the previous

sections. Although there is variation, the data show that the concentration of ownership in Latin America may be linked to the great potential for the extraction of private benefits from control.

### ***3.3. Insider Trading***

Another line of research that contributes to our understanding of the effects of poor shareholder protection across countries in Latin America is presented in Cruces and Kawamura (2007). The authors use intraday trading data on over 1,400 tickers in Latin American companies to compute an insider or informed trading probability (ITP).<sup>21</sup> Previous work on the subject argues that the ITP might be a good proxy for the intensity of privately informed trading and thus be related to the quality of corporate governance among firms. Controlling groups may be able to trade using insider information, and such trading could be detrimental to outside investors. The data of Cruces and Kawamura (2007) show that the ITP is correlated with some of the countrywide investor protection variables used in the literature and presented in previous sections. The paper also documents substantial increases in the ITP immediately before public corporate announcements, such as the release of financial statements or corporate governance announcements. These findings suggest that privately informed agents are trying to exploit their privileged information when it is most valuable.

Armed with this evidence, the paper estimates the relationship between the ITP and corporate valuation. The authors find that, after controlling for company characteristics, the ITP is priced corresponding to the market: companies with higher ITPs fetch a lower Tobin's  $q$ .<sup>22</sup> A fall of one standard deviation in the ITP is associated with an increase of one or two percentage points in valuation measures. The authors conclude that the ITP proxies for the unobservable quality of corporate governance because the heterogeneity of firm behavior seems to be recognized by the market and priced accordingly. Another unintended consequence of poor corporate governance is the increased probability that those in control of a firm and having access to information will be able to abuse their information and benefit from trading on securities before the information becomes public and impacts the stock price. In such cases, small shareholders are hurt because they are not able to do the same.

The evidence in this paper, the first evidence on Latin America and other emerging markets, suggests that there is substantial heterogeneity in firm behavior and, thus, corporate governance within a given institutional environment. Part of this heterogeneity seems to be

recognized by the market and priced accordingly. The results concerning the ITP lead us to the next section in this paper, on firm-level corporate governance characteristics beyond the country-wide measures.

#### **4. Firm-Level Corporate Governance**

To understand the options available to firms in Latin America, one might usefully follow Coffee (1999), who draws a distinction between legal and functional convergence. Legal convergence refers to the changes in rules and enforcement mechanisms that tend toward some desirable standard. According to the analysis of the evolution of legal investor protection in Latin America above, to achieve a legal convergence to effective investor protection, most countries in the region will require more drastic legal, regulatory, and judicial reform. An alternative path to reaching higher standards is functional convergence, which refers to more decentralized, market-based, and firm-level changes. Functional convergence does not require legal reform per se but still brings more firms and assets under the umbrella of effective legal protection for investors.

There are many mechanisms through which functional convergence may be achieved. First, firms may unilaterally try to improve their corporate governance practices and reform their statutes so as to adjust to practices and rules followed by other companies inside or outside the country. The firm-level improvement of corporate governance practices that depart from current legislation and regulation in the country seems the simplest form of functional convergence available to firms. Firms may opt out of legal rules in their corporate charters, which serve as the ultimate contract between the firm and its investors.<sup>23</sup> Although opting out of the standard rules sounds simple, it may prove costly in practice if investors or courts have difficulty understanding these special contracts. Enforcement becomes critical if there are departures from the norm.

A second and probably less risky option for individual firms trying to provide higher investor protection is adherence to a common set of voluntary principles that have been designed by experts and authorities. Such approaches have now become more widely available because the wave of corporate governance scandals has translated into the adoption of voluntary codes of best governance practice throughout the world. These codes have sometimes been created to facilitate the transition of firms into higher standards without forcing legal reform. Adhering to the code of best practice or some of its principles has the advantage that other firms may also be adhering, the authorities have blessed the code, and the code has probably already passed the

screening tests of lawyers in the country. This means that enforcement may be less of a problem than the unilateral adoption of different norms.

The third and final type of functional convergence involves foreign influences that may be exercised because a firm has listed abroad or has been acquired by a foreign firm that relies on a set of practices that are different from local ones. In both of these cases, the probability of enforcement in support of the improved practices is greater because courts and regulatory agencies of other nations familiar with these norms possess certain powers to intervene in case of disputes.

The use of one or more of these mechanisms of functional convergence means that firm-level corporate governance practices may differ within a country. If that is the case, we would find that, in countries with weak protection, some firms will not remain idle and will try to improve the local legal standard of corporate governance in an attempt to gain greater access capital. Functional convergence thus creates the need to analyze firm-level corporate governance practices within countries.

#### ***4.1. Firm-Level Samples and Corporate Governance Indicators***

Until recently, there had only been a handful of studies that used firm-level data to measure the impact of corporate governance. La Porta et al. (2000a and 2000b) and Daines (2001) have established that country and state laws have an impact on firm valuation dividend payout ratios. A new generation of studies looks beyond country-level measures and collects data on firm-level characteristics and corporate governance practices to analyze those impacts.<sup>24</sup> The papers reviewed here follow this approach by analyzing whether variations in firm-level governance practices are also associated with firm valuation, performance, and dividend payments.

The papers discussed here represent groundbreaking studies on Latin America, a region with a virtual vacuum of firm-level information relative to other regions. The studies have involved the collection of the most comprehensive and detailed firm-level data so far for Argentina, Brazil, Chile, Colombia, Mexico, and Venezuela. Because of data limitations, detailed and comprehensive country studies of firm-level governance practices are still rare, particularly for developing countries. This sort of analysis needs to encompass detailed firm-level data, including information on financial statements, performance, board composition and functioning, disclosure levels, minority shareholders rights, enforcement procedures, and fees

and compensation. The difficulty arises from the fact that some firms may not have the right incentives or may want to avoid disclosing this kind of information, especially in environments with weak financial markets or where there is little knowledge of the positive effects of good governance practices on corporate valuation and performance.

To address the issue of the measurement of corporate governance, the papers reviewed look at the literature on firm-level analysis. Based on this information, the authors have developed a unique questionnaire, trying to keep the questions consistent across jurisdictions in the region so as to facilitate cross-country comparisons. In itself, this has represented an unprecedented step in this region. The additional effort at coordination among the research teams is a reflection on the quality of the data that have been generated.

Table 14 summarizes the types of efforts at convergence revealed through the questionnaire by firms across the Latin American countries covered in this paper based on information supplied for 2003–04. The questionnaire was developed by the editors, in collaboration with the authors of the papers. It has been based on the various indicators identified in other studies<sup>25</sup> and supplemented with additional questions to examine the poor level of investor protection in the region. This meant that some basic questions about the legal protection of investors that may not have been necessary in other, more protective regions needed to be adapted and added to the questionnaire. Similarly, because of country differences in regulation and the level of protection, some questions are adapted to address the laws of each country.

The questionnaire was typically sent to the officers and board members of each corporation. In most countries, the information was supplemented or corroborated through reliance on as many sources of publicly available information as possible. Table 14 shows that the questions covered nine basic areas of corporate governance: (1) the general characteristics of firm governance; (2) principles of corporate governance; (3) board structure and the characteristics of board meetings; (4) the characteristics and functions of board committees; (5) external auditors and other independent experts; (6) financial disclosures; (7) conflicts of interest, including related party transactions, as well as ownership structure, deviations from one share–one vote rules, compensation and nomination; (8) shareholder rights and the workings of the shareholder meetings; and (9) the experience with sanctions and recent known governance problems in the firm. In general, the questions in each of these categories were tailored to all the



countries included. The number of questions across countries ranged from 20, in the case of Chile (which has the highest level of mandated disclosures and other shareholder protections in the region) to 70 in the case of Venezuela.

Despite the known difficulties in gathering together such information, extensive groundwork and creative ways of using available information have allowed the researchers to collect firm-level longitudinal data on at least half of the listed firms in each country, which represents around 70 percent of the total market capitalization in these countries (see Figure 6 and Figure 7). In terms of financial and operational measures, the authors of all the papers used several sources to create panel data sets that included quantitative variables and that, in some cases, span more than a decade.

The studies reviewed in this paper are largely homogeneous in their analysis on issues related to the effects of corporate governance in terms of various performance and valuation measures, but each of them also departs from the others and investigates additional questions that are relevant to specific markets. The authors provide a descriptive analysis of ownership structures and the separation of ownership and control in Colombia, Brazil, and Chile. In the case of Venezuela, the authors try to assess the relationship between performance, the earnings of chief executive officers, and the role of boards in monitoring chief executive officers.

#### ***4.2. Firm-Level Corporate Governance Practices and their Impact***

In this section, we briefly describe the most salient differences in corporate governance among firms within each of the countries examined in the paper and the impact of the related measures on various valuation, performance, and dividend payout ratios. Using the data samples described in the previous section, we highlight interesting facts regarding the corporate governance of firms within each country and its relationship with firm performance.

There are two patterns that are common across the six countries (Argentina, Brazil, Chile, Colombia, Mexico, and Venezuela) that reported a firm-level corporate governance index: (1) the average firm in most countries exhibits a low overall score, and (2) there is wide variation in the practices across firms within each country.

Firms in all three Southern Cone countries (Argentina, Brazil, and Chile) show higher scores in the disclosure of the index. Argentine firms seem to perform poorly when we look at the average index computed, scoring only 39.1 of a possible 100 points. As in most countries,

there is wide variation in the index across firms, ranging from 18.8 to 84.4 points. On sub-indices, the highest average score is for disclosure (49.4), and the lowest is for board characteristics (28.4).

Meanwhile, in Brazil, the average index in the sample was 10 of a possible 24 points, and the range was between 4 and 19. Brazilian firms also score relatively better on disclosure. On the other hand, they score low on the shareholders rights sub-index. Despite improvements in recent years, compliance with good practices by boards and avoidance of conflicts of interest remain low in Brazil.

Chilean firms also show better performance in disclosure and information (5.14). The score on the category of boards and officers is relatively high, too (4.54), with the worst score on general principles (2.63).

The other three countries in the region show larger differences. Firms in Colombia and Venezuela exhibit relatively low overall scores, while firms in Mexico seem to have improved over time.

More specifically, the implementation of corporate governance practices in Colombia has been poor: half the sample scores less than 47 of 100 points. The average Colombian firm does not seem to foster board independence and discipline.

Venezuelan public companies also exhibit relatively low corporate governance scores overall, with an average score of 3.79 out of 7. As in the case of Argentina, Brazil, and Chile, the best performance is on the disclosure and information section of the questionnaire. In the section on general principles, the results are similar to those for Chile: a large number of Venezuelan firms do not adhere to the international code of conduct. In terms of the questions pertaining to the officers and boards, the most salient finding is that, for almost half the companies surveyed, the chief executive officers were also the chairmen of the board and belonged to the same family or control group. Finally, only slightly more than half the companies acknowledged having independent board members, and a handful had corporate governance committees.

The creation of the corporate governance code for publicly traded firms was a significant source of improvement in firm-level practices in Mexico. By 2003, the average listed company met 78.4 percent of all the recommendations in the code. A year later, more than 90 firms in the sample (150) met more than 80 percent of the code's recommendations. Although compliance is increasing, there is still a lot of variation: firms comply with between 30 and 98 percent of the

recommendations. Among the specific areas, compliance ranged from 53 percent with the recommendation regarding the committee of evaluation and compensation to 90.3 percent on the recommendations related to the duties of directors.

Each of the papers reviewed here includes a set of econometric results that relate corporate governance indicators to various outcome measures. But the most distinctive feature of these papers is the fact that all the authors have sought to reach a common ground so as to be able to analyze the impact of firm-level corporate governance practices in terms of measures of valuation, performance, and dividend payout ratios. We should clarify that, because of the various data limitations in each country, not all outcome measures are available, and the econometric procedures that the authors have been able to use have also differed in some cases. All the authors performed analysis following the ordinary least squares methodology. However, because it is possible that certain types of firms are more likely to adopt better corporate governance practices, most authors discuss alternative econometric procedures to address this endogeneity issue.<sup>26</sup>

Several firm characteristics relating to the intrinsic nature of firms, their assets, or their cash flows may be a source of endogeneity in this kind of study. The size or the age of a firm likewise might affect corporate practices. The operations of a small firm may be more easily understood and monitored, while larger firms or firms in multiple industries would have potentially larger agency problems and might thus seek to adopt better corporate governance. Similarly, firms with lower tangible assets may be more difficult for investors to monitor and would thus require better governance practices.<sup>27</sup> Additionally, firms with large, free cash flows might cause investors to become more concerned about potential expropriation and might thus adopt better corporate governance measures to keep investors happy.<sup>28</sup> Probably one of the larger sources of concern are unobserved future growth opportunities that might lead controlling shareholders and managers to improve corporate governance to increase their chance of tapping capital markets or reduce the cost of capital. In such cases, valuation measures are also likely to be determined with a view to anticipated future growth.

As elsewhere in the literature, the papers analyzed here try to disentangle the corporate governance effect on performance and valuation measures by controlling for several company characteristics likely to be associated with higher growth prospects and greater needs for monitoring because of the nature of firm assets, cash flows, and firm size. All regressions control

for key company characteristics that the theory predicts should have an impact on valuation or performance measures. The regressions typically include measures of size, indebtedness, profitability, and growth. The analysis also tries to take into account potential endogeneity problems emerging from the nature of firm assets or cash flows, especially in light of the differences across industries; industry-level fixed effects are considered whenever possible. Most authors also rely on methods involving some instrumental variables to provide robustness to the results of ordinary least squares.

Although the samples and econometric methodology of each of the studies vary, some numbers may be compared across countries. To provide a rough overview of the analysis of the effects of corporate governance, we summarize some comparable results in Figure 8 and Figure 9. These two figures look at the impact of the corporate governance index developed in each country on Tobin's  $q$  and dividend payouts, respectively.

There are several potential outcome variables at the firm level that fall in the categories of valuation, performance, and payout ratios. Among valuation measures, the most commonly used in the literature is Tobin's  $q$ ,<sup>29</sup> but several studies also analyze the price-to-book ratio for robustness purposes. An argument might be made that valuation measures are the prime variable for capturing the effect of firm-level corporate governance. According to the model in La Porta et al. (2002), improved valuations deriving from better corporate governance are the result of the higher confidence of investors that controlling shareholders will have less means to expropriate the cash flows of the firm. Better firm-level governance makes investors more willing to provide capital to firms at lower cost, and this is reflected in higher valuation multiples.

As Figure 9 shows, controlling for endogeneity issues to the best of the ability of each data set, there is a positive impact on the valuation of firms across the region. The graph illustrates the percentage change in firm valuation that would arise from an increase by two standard deviations in the corporate governance index of each country. The largest impact is in the case of Mexico, which shows large returns. Mexico is followed by Argentina and Venezuela, where a jump of two standard deviations in the index would increase Tobin's  $q$  by 30 percent. The results in the papers (on Brazil, Mexico and Venezuela) that use price-to-book ratios are also very similar. The findings regarding the impact of corporate governance practices on valuation are large and significant. They support earlier results for samples of firms in emerging markets examined in Klapper and Love (2002) and, for Korea, in Black, Jang, and Kim (2006).

Although valuation ratios are likely to be the best measure for capturing the impact of higher firm-level governance, performance measures might also be affected. One might argue that firms with better governance are also better run, probably because better mechanisms are used to face changing conditions or new opportunities. If this is the case, then these firms would show higher returns. Following this logic, several studies also analyze the impact of corporate governance on performance ratios that include return on assets and return on equity. It is worth noting that the rationale behind a positive association between performance and governance relies on a notion of market inefficiency that causes investors to underestimate the full impact of higher agency costs in poorly governed firms. Some recent papers have tested this hypothesis for other countries and have found that governance exerts a positive effect on operating performance.<sup>30</sup> The authors have sufficient data on Argentina, Mexico, and Venezuela to analyze the association between the corporate governance index and the return on assets and the return on equity. The results are positive, but smaller than those of valuation measures. For the case of Colombia, using data for 2004, the authors find a significant association between the return on assets and the corporate governance index, although the economic effect of the findings is small.

Figure 9 summarizes the results across the papers that perform an analysis of the impact of firm-level corporate governance on dividend payout ratios. According to the outcome agency model of dividend payments specified by La Porta, López-de-Silanes, and Shleifer (2002), firms with stronger governance practices should have higher dividend payouts. The results in Figure 9 support the view that stronger firm-level governance practices are associated with higher dividend payouts. To provide a magnitude of the effect, an increase by two standard deviations in the corporate governance index is reflected in a doubling or tripling of the mean dividend payout ratio for three of the four countries for which data are available. These effects are twice as large as those for regressions that do not account for endogeneity. The only country where the impact of dividends is small, but still positive, is Brazil.

Overall, these figures are very revealing and embody the basic message of our paper: individual firm-level corporate governance measures do have an effect on the valuation and the amounts of dividends that are delivered to shareholders. In line with other evidence for other countries, these results support the view that firms providing a better package of governance measures are more highly valued by markets and distribute more profits to shareholders.

## **5. Firm Migration and Disappearing Stock Markets**

The challenges for Latin American stock markets are huge because of the proximity of Wall Street. The existence of cross-listing programs in the United States and other countries with large stock markets provides firms with an alternative mechanism to escape the low levels of general legal protection on their local markets. The most common form of cross-listing is a depository receipt program. These programs exist in the main stock exchanges in the United States and other places such as Hong Kong (China), London, Luxembourg, and Singapore. Depository receipts are negotiable certificates that are denominated in the currency of the market where they are traded and that represent the ownership of shares in a foreign company. These certificates may be traded over the counter or in organized exchanges, and they may be either capital raising or not.<sup>31</sup>

Cross-listing abroad has been perceived by some as a mechanism to foster improvements in firm-level corporate governance practices because of links to U.S. markets, which have higher corporate governance and disclosure standards than the average Latin American country. Coffee (1999) and others (for example, Karolyi 2004 and 2005) argue that cross-listings represent an important movement toward functional convergence to U.S.-style corporate governance. The recent gains in Hong Kong (China) and London as favorite cross-listing locations mean that, except for Luxembourg, the largest cross-listing centers are located in common law countries, which rank systematically higher in measures of legal protection for investors.

The quality of the laws and of law enforcement seems to be an important factor among firms wanting to cross list. Sarkissian and Shill (2004) provide empirical evidence that foreign firms list in markets with better investor protections, where they are provided with higher liquidity and a larger shareholder base. Firms may also wish to migrate to avoid certain exchange controls, transaction costs, trading taxes, or clearance and settlement risks in local markets. Differences in tax regimes may also be a motive for listing abroad. To lure them to their capital markets, tax havens and markets in Hong Kong (China), Luxembourg, and Singapore offer tax concessions for foreign firms.

Thus, cross-listing may bring several advantages for firms. First, entering an international capital market may send a signal to investors about the firm's quality and commitment to increased disclosure and protection, leading to higher equity valuations. Second, because

financial markets are not fully integrated, entering foreign markets may simply lower the cost of capital as the premium on once hard-to-get stocks is reduced. Third, diversifying and increasing the investor base through a foreign listing may also improve a company's capacity to access capital and exploit growth opportunities. A fourth advantage may arise from the additional publicity that is attached to the cross-listing and that tends to enhance the image and visibility of a firm's products. A larger investor base and increased investor recognition lower information costs and may therefore affect the cost of capital.<sup>32</sup> Higher liquidity is a fifth reason for listing abroad; this may allow a firm to avoid funding reductions during periods of negative domestic shocks and local market contraction. Finally, although less common, cross-listed shares are easier to use as currency for foreign acquisitions.

However, cross-listing is not simple and may also be costly. First, there is the classic home bias of investors, who have a demonstrated preference for familiar assets.<sup>33</sup> Reducing this bias is simpler for firms in countries with significant cultural, language, institutional, geographical, or trade ties. Sarkissian and Schill (2004) show that all these factors facilitate cross-border listings. Second, for controlling groups, the flip side of increased investor protection is more transparency, less flexibility in exerting power over shareholders, and a greater probability of losing dominance in the firm.<sup>34</sup> The recent wave of improvements in corporate governance standards and the potential penalties imposed for violations also increase the threat to controlling shareholders if they enter foreign markets. Higher disclosure standards also mean higher financial costs for reconciling and adopting international accounting standards. Recent evidence shows that accounting costs in the United States have nearly doubled since passage of the Sarbanes-Oxley Act.

The empirical evidence suggests that, despite the potentially high costs, firms that cross-list are perceived by the markets as benefiting overall. Foerster and Karolyi (1999) were among the first to illustrate these benefits in a series of studies on a large cross-section of countries. The data indicate that a firm listing shares in the United States experiences a positive change in its share price at home and improves its subsequent access to external capital markets. There is also evidence that listing in U.S. markets is perceived as a commitment by the firm to higher shareholder protection. Lins, Strickland, and Zenner (2003) show that there is a decline in the sensitivity of investment to cash flow when an ADR is issued by a company from a country with a weak legal system and a less well developed capital market. Reese and Weisbach (2001) find

that companies in French and Scandinavian civil law countries are more likely to list ADRs on an organized exchange in the United States. This means that ADRs seem to be used as a partial substitute for weak legal institutions because they represent a commitment by firms to greater disclosure. The increased protection mainly comes through the stricter disclosure requirements,<sup>35</sup> but it may also be the result of the threat of action by the foreign regulatory authorities, who may undertake damaging investigations and legal suits that might end in delisting and other financial penalties.

Probably as a result of a combination of improved investor protection and the other market-access arguments outlined above, firms from all parts of the world have been cross-listing in the United States and, more recently, in other large exchanges. The movement toward Wall Street by firms in other jurisdictions has been significant over the last 50 years (see Figure 10). After an early period of little growth in cross-listings, foreign listings on the New York Stock Exchange began surging around 1986. The 1990s were the years with the largest growth in this market as firms moved away from issuing the traditional over-the-counter or level 1 depository receipts and started to engage more in exchanged-listed (levels 2 and 3), Rule 144A, and global depository receipts. From 1990 to 1996, the number of depository receipt programs doubled to almost 1,500. Figure 10 shows this explosion: the number of ADR programs listed on the New York Stock Exchange reached an all-time high of over 450 in 2001–02.

Figure 11 takes a closer look at the change in the composition of depository receipt programs in recent years. The figure shows continuous growth at first and a small setback in 2003–04. By mid-2006, the market had recovered and reached a new record of 1,943 depository receipt programs from 75 countries available to investors. The figure illustrates that foreign issuers have continued to increase their participation in the depository receipt market, but the bulk of the increase has not come from U.S.-listed programs. Instead, the increase is explained by level 1 ADRs in the United States and, above all, global depository receipts going to Hong Kong (China), London, and Luxembourg.

Since 2001, the number of U.S.-listed depository receipt programs has shrunk by over 10 percent, reaching a nine-year low of 473 in June 2006. There are new listings every year, but more issuers have left U.S. exchanges. Some of the reasons behind these include mergers, acquisitions, and financial difficulties. The U.S. market downturn of 2002 may have been another important reason behind the reduction in listed ADRs. But the change in the composition



of cross-listings observed in the past few years may also have other, more structurally related causes. The expansion of foreign stock markets and the reduced attractiveness of the U.S. economy as a whole translate into a reduced advantage for U.S. markets in attracting capital. Additionally, the levels of investor protection, supervision, regulatory burden, and liability risk have risen in the United States, notably with the passage of the Sarbanes-Oxley Act in 2003 and a stream of litigation that followed the collapse of Enron. Indeed, there are fears that some features of the new rules are too expensive, particularly for small firms. These concerns have already led regulators to analyze rule changes to lighten the burden. In November 2006, a special independent committee on capital markets regulation issued its first report, which proposed that more cost-effective regulation and a reform of the U.S. litigation and enforcement system may be needed to regain competitiveness relative to other large markets. This does not mean less regulation or lower levels of protection. In fact, some of the recommendations call for stronger shareholder rights to bolster the market for corporate control. But it does suggest reconsidering the costs and the benefits of existing rules that have generated a substantial increase in litigation that may also harm investors.

Although there seems to be a push for reform in U.S. capital markets, the recent numbers should provide some comfort. The past two years have seen higher levels of activity, similar to the late 1990s. Figure 12 shows that the annual capital-raising value of primary and follow-on depository receipt offerings have surpassed the previous record set in 2000. The figure illustrates two important points. First, it is clear that a few markets outside the United States are currently attracting foreign cross-listings. Unfortunately, none of these markets are in Latin America. Second, although the number of new U.S. listings is not rising rapidly, the U.S. markets are still raising large amounts for return issuers. The capital raised through depository receipts on U.S. exchanges in 2005 was the second largest annual amount in the last decade, behind only the amount in 2000. Additionally, although competition from other exchanges has impacted U.S. exchanges, more than 90 percent of cross-listers still choose to market their shares to investors in the United States under Rule 144A.

Latin American firms have additional incentives to enter the U.S. markets because of the product market and investor base, or simply geographical reasons that render trading more synchronous with their own local markets. For all these reasons, companies in the region are flocking to U.S. listing or going over the counter, and the United States remains is still the most

relevant choice for firms in Latin America that want to migrate.<sup>36</sup> Over the last 15 years, there has been a large, steady movement of cross-listings by Latin American firms. Figure 13 shows the composition of ADR listings in 1990 and in 2003, and the increasing participation of Latin America in this market is impressive. In 1990, the only Latin American country with significant participation was Mexico, which ranked 19th, with less than 1 percent of all ADR listings. The situation had completely changed a decade later. By 2003, Mexico and Brazil were the sixth and seventh largest contributors to ADR listings. That year, these two countries had over 9 percent of all cross-listings.

Hong Kong (China), India, and Taiwan (China) have recently moved to the top of the list in depository receipt listings. Meanwhile, the share of Latin America in the overall market has not really changed. Nonetheless, Latin American depository receipt programs represent close to 13 percent of all available programs in the world. In 2005–06, Latin American companies accounted for five of the largest 15 depository receipt programs in the world and five of the top 20 most actively traded U.S.-listed ADRs.<sup>37</sup>

Figure 14 illustrates this trend. It indicates the large number of new firms in Brazil, Mexico, and, to a lesser extent, Argentina and Chile that are entering the cross-listings market. The figure shows that firms in the region are still using U.S. markets as an important mechanism to access investors and raise capital. In 2005, two of the top 20 capital-raising depository receipts were Latin American, and that number doubled in 2006.<sup>38</sup> For the majority of the past 15 years, capital raising via ADRs has been larger or similar to the capital raising by Latin American firms in their respective local markets.<sup>39</sup>

Firms in Latin America favor the U.S. markets for the simple reason that these markets provide them with access to the capital they need at a lower cost. There is empirical support for the idea that firms in countries with poor shareholder protections may want to migrate or cross-list in places with stronger investor protections because these markets are larger, more inclusive, and more valuable and thus provide them higher valuations.<sup>40</sup> The bonding theory of international cross-listings proposed by Coffee (1999, 2001) and Stulz (1999) seems to be borne out by the data: the lower cost of capital experienced by U.S. cross-listers derives mainly through the benefits of bonding to the laws and regulations that govern firms in more protective markets.<sup>41</sup> Figure 15 illustrates the evidence on this issue for a large sample of foreign firms cross-listing in the United States from all over the world. The first chart shows that there is a

positive valuation premium, or lower cost of capital, for firms with cross-listed securities. The average Tobin's  $q$  of firms that cross-listed in the United States between 1997 and 2004 was 14.6 percent for all countries and 13.3 percent for Latin American firms. These numbers are even higher for those firms that cross-listed on U.S. exchanges (ADR levels 2 and 3), reaching 31.7 and 29.6 percent for all foreign and Latin American companies, respectively.

The current debate on the decline of U.S. markets is partly fueled by the observation that the valuation premium on cross-listing has severely decreased since 2001.<sup>42</sup> The data in Figure 15 show that, if we compare the average premiums of the period before and after 2000, the average pre-2000 premium falls by approximately 45 and 58 percent for all firms cross-listed and those cross-listing in a U.S. exchange, respectively. The source of the reduction in the premium is still an open question. It might include the reduced benefits of higher regulatory costs in the United States or the improvement in corporate governance in stock markets outside the United States. What is important for Latin American markets is that, for whatever reason, the premium for Latin American firms has not been reduced at the same rate. In fact, the post-2000 valuation premium reduction for cross-listers in the region has only been reduced by between 20 and 23 percent. These findings go hand in hand with the findings outlined elsewhere above that the corporate governance environment in Latin America is still lagging. The lower rate of premium reduction may reflect the relatively poor improvement of corporate governance in Latin American countries.

Figures 16, 17, and 18 show additional statistics that portray the large migration to northern markets.<sup>43</sup> The data in these figures also indicate that Latin American markets are highly connected and synchronized with U.S. markets through cross-listings. Measured as a percentage of issuers, or of market capitalization, or of value traded, ADR firms are growing at an increasing pace. Mexico has the largest percentage of locally listed firms that have ADRs in the United States. Figure 16 shows that, for the average Latin American country, close to 50 percent of the most important stocks have a U.S. cross-listing. The number had reached 80 percent of all the large issuers in Mexico and Venezuela included in the Standard & Poor's–International Finance Corporation Global index in 2000. The number of Brazilian and Chilean firms also increased substantially. This evidence supports the view that, in countries with weak investor protection, firms seek ways to gain access to external capital markets. The numbers in Figure 17 and Figure 18 are even more startling. With the exception of Colombia, the capitalization of

firms with ADRs was above 60 percent of the total capitalization of firms in the Standard & Poor's–International Finance Corporation Global index, and the proportion of value traded of firms with ADRs was, on average, 70 percent of the value traded among the firms included in the same index. The share reached over 80 percent for Argentina and Mexico in 2000.

Listing abroad seems to be a good alternative for Latin American firms. The evidence shows that, in addition to the lower cost of capital, firms that cross-list experience a reduction in capital constraints and are able to tap more easily into domestic and foreign debt markets. Overall, there seems to be a large positive impact on financial costs and a reduction in local market volatility. One might wonder, then, if the positive impact on cross-listers has any positive externality in terms of local issuers.

Theoretically, the impact of cross-listings on local market development may be positive or negative. It seems that, if investors learn more about several firms in a market, they might use some of that information to assess firms that remained listed only locally; this would have a positive spillover effect. The migration of companies to the ADR market would represent a first step in the integration of the local market with the more liquid and better-developed U.S. market. As more firms cross-list, local financial intermediaries would face more competition, which would force them to improve. Cross-listers would start a positive spiral leading to financial innovation by intermediaries and market development overall.<sup>44</sup> The pressure from ADRs may also be expected to have a positive impact on investor protection because authorities and regulators would face the challenge of competition and be pushed to improve disclosure standards and shareholder rights.

The predictions of this theory do not seem to square with the concern of policymakers in many countries who perceive the growth of depository programs as a threat. An alternative theory on the effects of cross-listing predicts, in fact, an effect that is exactly the opposite of the effect described above. Firm migration abroad may hurt the liquidity of the firms that remain in the local market.<sup>45</sup> As firms cross-list, there might be a diversion of local activity to the foreign market that would lead to a fragmentation of local markets and a reduction in local liquidity. Instead of being a source of the local development of local markets and intermediaries, depository programs would be the catalysts of investment and trading diversion. The result would be an inhibition of growth as the local market becomes less relevant.<sup>46</sup>

Unfortunately for Latin America, the bulk of evidence points to negative rather than positive externalities on local markets from large firm migrations through depository programs. Using different samples with different country coverage and time spans, most of the authors analyzed in this paper find that cross-listing leads to lower local liquidity and the reduced ability of non-migrant firms to access capital. ADR growth has a negative impact on new local listings and overall market growth.<sup>47</sup> The impact varies across regions, and African and Latin American markets are the most negatively affected by depository receipt programs. Moel and Tufano (2002) find that the impact is quite severe for listing new firms in local markets; their estimates suggest that a local IPO is lost every time a new firm cross-lists. Karolyi (2005) confirms these results: ADR activity, measured in terms of the number of programs and their market or trade value, has a negative impact on domestic markets, though this impact is confined to non-ADR issuers. His results also show that exchange-listed ADRs, rather than the Rule 144A ADRs, that are the drivers.

There is additional evidence showing that the process of international market integration through cross-listings is more complex and that there are unexpected, negative side effects. Melvin and Valero-Tonone (2003) analyze the impact of a cross-listing firm on home-market rival firms. Theoretically, this impact would be positive if there is a positive spillover effect in the cost of capital for all firms in the same sector because one of them has started a depository program. The empirical results of Melvin and Valero-Tonone show the opposite, however: there are negative cumulative abnormal returns for local rival firms at the announcement of the new program and on the listing dates. Investors perceive that firms without depository receipts are less transparent and represent poorer growth opportunities. This negative effect is at least twice as large for firms in emerging markets, such as in Latin America.

The past five years have seen other stock markets competing more vigorously against the hegemonic position of Wall Street. Asian and European markets are gaining ground and have started to list more and more global issuers. Latin American markets contrast sharply with these newcomers: virtually no foreign firm lists in Latin markets. Although ADRs are facilitating the integration of local markets in world capital markets,<sup>48</sup> this greater synchronicity among markets has arisen through the link provided by Latin American companies that are going the other way around by cross-listing elsewhere. The data show that the degree of regional integration is also close to zero. With the exception of a few Argentine companies that list in Brazil, there is no

regional stock market integration to speak of, and no Latin American market has become an attractive alternative pole to compete with U.S. markets or to begin generating regional integration. The isolation of Latin American stock markets should be a matter of policy concern, as greater competition among markets may lead to consolidation through alliances, mergers, or market shutdowns in emerging markets

In summary, the search for capital by Latin American firms that are trying to gain access on Wall Street through cross-listings has been successful. Latin American cross-listers are among the largest and most traded securities on this market. Foreign markets are thus serving as a valve for some firms by facilitating their access to external finance. But such opting in cannot fully replace legal reform in the region because the vast majority of Latin American firms are not sufficiently large to access U.S. markets, particularly given new regulations. If local markets dry up, many firms will be deprived of a vital source of capital for facing foreign competition. For most countries in Latin America, the threat posed by Wall Street should alert policy makers to the urgent need to improve local investor protection standards, an effort that requires changes in regulations and improved judicial mechanisms to enforce rights.

## **6. Conclusions and Policy Implications**

The basic argument running through the studies reviewed in this paper is that, even under distorted conditions, with insufficient legal shareholder protections and poor enforcement—the situation in most Latin American countries today—capital market access may be improved if firms depart from the norm and begin adopting better corporate governance practices. Improvements in firm-level governance foster reductions in the margin for conflict between large and minority shareholders as companies become more transparent. Companies that chose to take this path are welcomed by the markets, which attach to them higher relative valuations and thus lower the cost of capital.

This paper provides a framework for understanding the trends in and the limitations of firm-level corporate governance reforms in the region. As the cross-country evidence shows, investor rights are not inherent to securities, but are determined by laws. Investors in different legal jurisdictions have different bundles of rights. Countries in Latin America suffer from a generally lower level of protection, partly inherited from their legal traditions. The weaknesses of the region's capital markets are exacerbated by the relatively low enforcement levels in most

of the countries under analysis. The inadequacies of the legal institutions in Latin America generate high levels of ownership concentration, poor access to external equity financing, and narrow equity markets.

A first level of policy recommendations suggested in this paper is directed at improving corporate governance by putting it at the top of the policy agenda in Latin America. The evidence surveyed calls for wholesale legal reform. Cross-country studies show that minority shareholders would benefit from the existence of disclosure mechanisms that improve transparency and from mechanisms to address expropriation.<sup>49</sup> There is currently plenty of room to strengthen voting rights and to enhance disclosure requirements in the region.

One of the key challenges in Latin America is the effective enforcement of legal standards. Improving the judicial means of enforcement should be viewed as a policy step that reinforces legal reform. A well-functioning, politically independent judiciary reduces the danger that regulators may be captured. However, to the extent that improving the efficiency of the judicial system and asserting the rule of law are slow processes, it is important to incorporate tools to address these constraints in the policy design. Sometimes, standards and rules are too difficult or too impractical to enforce. In such cases, it may be appropriate to adopt simpler bright-line rules. An example would be the adoption of an oppressed minority mechanism, perhaps similar to that in Chile, that minimizes the involvement of the courts even if its more mechanical nature results in outcomes that are less than fair. Similarly, mandating enhanced disclosure requirements may not be sufficient in countries with weak legal institutions. In such instances, it may be desirable, for example, to require that institutional investors only be allowed to invest in companies that meet minimum corporate governance standards as determined by independent best-practice commissions. Similarly, as López-de-Silanes (1999) shows, legal reform must also be politically feasible.

In the absence of a good legal environment, the evidence surveyed here suggests that access to financing by firms in the region requires that companies undertake significant efforts to protect financiers. Expropriation by entrepreneurs may be considered a serious threat because of the lack of good enforcement mechanisms.

The studies reviewed in this paper portray what may be regarded as the demand side as local firms seek capital. The firm-based analyses suggest that domestic and foreign capital is available to sustain larger stock markets that are more active in valuation and to make viable the

investment projects of firms that decide to reform and seek public capital. In this respect, there is an implicit assumption that supply forces may work their way in to the markets if providers of capital are permitted entry. Although the economies in the region are not characterized by an abundance of idle capital, the experience of several emerging markets that have opened up in recent decades suggests that capital will flow if the barriers are lowered.

There are reasons to believe that the situation is more promising in most Latin American countries today than it was 25 years ago. Throughout the 1980s and 1990s, most countries in the region underwent a series of market reforms and macroeconomic stabilization measures that opened up their economies to competition. A series of legal reforms opened up investment in what had been considered strategic investment areas and allowed foreigners to take part in the large privatization programs of the late 1980s.<sup>50</sup> In some instances where access to privatizing state-owned enterprises was restricted to domestic capital, the financial crises of the 1990s in Argentina, Brazil, and Mexico led to a relaxation of the rules and opened up these sectors to foreigners. A notable example is the case of the Mexican banking sector, where foreign capital was not allowed in during the initial round of privatization; 10 years later, virtually no major bank remained under domestic control.<sup>51</sup>

There are two exceptions to this generalized process, however. First, key mineral sectors and oil have not yet become fully liberalized to outside capital. Second, in the last few years, countries such as Bolivia and Venezuela have turned their backs on liberalization policies. In both cases, the isolation that industries and countries are facing will come at the cost of additional lags in the access to the resources needed to achieve a healthy level of competitiveness. It remains to be seen if such policies are viable in an interconnected world.

The growing interconnectedness of markets is creating additional problems in the development of capital markets in the region. Reform in the region is facing an uphill battle because of the increasing connectivity of capital markets across countries. Chile represents a good example for others in the region because of its reforms and transparency, as well as the adequacy of its legal environment and enforcement. Yet, it seems that all these attributes have not spared Chile from the recent shrinkage in the number of listings. This pattern of fewer listings and more delistings is also evident in Colombia, Mexico, and Venezuela.

Skeptics of the benefits of reform have pointed to the recent trend toward delisting as a failure of efforts at improved investor protection and governance. The papers on Argentina and



Mexico voice this concern. Of course, the alternative hypothesis is that reforms have not gone far enough to prevent the massive exodus of firms to other markets. The access to U.S. capital markets through ADRs has provided an additional source of funds for some firms in the region. Such alternatives provide some explanation for the shrinkage in Latin American capital markets and are a stimulus for firms in the region to adopt better governance practices unilaterally. What matters to firms is access to finance, irrespective of the origin of the finance.

But integration with international financial markets does not eliminate the need for vibrant local financial markets. International markets are not appropriate for all firms. The constant threat of Wall Street poses real challenges for policy makers in the region. Although the gap between the level of protection in the average Latin American country and that in the large capital markets of the United Kingdom and the United States is large, stagnation and lack of change and reform in the region would do nothing but foster an even larger exodus over the medium and long run, putting countries in the region at the mercy of foreign investment. The experience of the recent governance reforms in U.S. markets has even prompted European economies to support reform to reduce the reliance of their firms on U.S. markets. In the end, reforms in other markets trickle down through firms that want to access those markets and hurt firms that have not yet taken the leap. If governments in Latin America do not want to create a two-tier structure in regulation, which would hurt medium-size firms the most, the imperative to catch up with the reforms abroad is paramount.

It took a series of financial crises in Brazil, Russia, Thailand, and the United States to heighten concern for corporate governance reform. Since these crises, the perceived threat of a global financial meltdown has waned. The danger for Latin America is that local efforts to improve corporate governance in the region will lose momentum as a result of the more stable financial markets. If this turns out to be the case, it is hard to foresee how local markets will be able to survive the next series of shocks.

## Notes

<sup>1</sup> Chong, Inter-American Development Bank; López-de-Silanes, University of Amsterdam and NBER. We are grateful to Gianmarco León for providing excellent research assistance and insightful comments. The views presented here are those of the authors and in no way represent the views of the Inter-American Development Bank or its Executive Directors. Corresponding author: albertoch@iadb.org, 1300 New York Ave., NW Washington, DC 20577; telephone (202) 623-1536; fax (202) 623-2481

<sup>2</sup> See Claessens et al. (2006); Kumar, Rajan, and Zingales (2001); La Porta, López-de-Silanes, and Shleifer (1999, 2002, 2006); La Porta et al. (1997, 1998, 2000a, 2000b); La Porta et al. (2006); Wurgler (2000).

<sup>3</sup> Countries have been included in the analysis generally only if they possess a stock exchange. This restriction gives the following list of Latin American countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Panama, Paraguay, Peru, Trinidad and Tobago, Uruguay, and Venezuela.

<sup>4</sup> The countries (and papers) analyzed here are Argentina (Bebczuk, 2007), Brazil (Leal and Carvalho da Silva), Chile (Lefort and Walker, 2007), Colombia (Rodríguez and Pombo, 2007), Mexico (Chong and López-de-Silanes), and Venezuela (Garay and Gonzalez, 2007), and finally a general case of insider trading for all Latin American countries (Cruces and Kawamura, 2007).

<sup>5</sup> See Klapper and Love (2002); Gompers, Ishii, and Metrick (2003); Black, Jang, and Kim (2006).

<sup>6</sup> ADRs are negotiable certificates that are denominated in dollars. They stand in for the ownership of shares in foreign companies and may be traded on U.S. exchanges. For more on depository receipts, see the section on firm migration and disappearing stock markets.

<sup>7</sup> La Porta et al. (1997, 1998) capture some of these effects in cross-country analyses by looking at institutional quality over the past 20 years and the impact of GDP per capita, which is a good summary measure of political and economic success.

<sup>8</sup> See La Porta et al. (1997, 1998).

<sup>9</sup> See Modigliani and Miller (1958).

<sup>10</sup> See Grossman and Hart (1986).

<sup>11</sup> Most English-speaking countries belong to the common law tradition based on the British Company Act. The common law family includes former British colonies and other nations such as Israel and Thailand that have modeled their initial corporate laws on the laws of England. There are 20 common law countries in the sample. The rest of the world belongs to the civil law tradition, derived from Roman law, which has three main families: the French family based on the Napoleonic Code of 1804, the German family based on Bismarck's Code of 1896, and the Scandinavian family, which legal scholars describe as less derivative of Roman law and distinct from the other two civil families. The French legal family includes France, Portugal, Spain, and their colonies. There are 29 French legal origin countries in our sample, including 19 in Latin America. The German tradition has had less influence, and we have only six countries in this family: Austria, Germany, Japan, the Republic of Korea, Switzerland, and Taiwan (China). Finally, the Scandinavian family includes the four Nordic countries of Denmark, Finland, Norway, and Sweden. For a fuller explanation, see La Porta et al. (1998).

<sup>12</sup> We should be careful about strictly comparing the specific variables in Table 1 and Table 4 since the definition of some of the variables in these two tables has been refined for the numbers in 2005.

<sup>13</sup> The La Porta, López-de-Silanes, and Shleifer (2006) sample, like that in La Porta et al. (1997, 1998), consists of the 49 countries with the largest stock market capitalization in 1993 (see La Porta et al., 1998 original sample).

<sup>14</sup> See Diamond (1989, 1991); Gomes (1996).

<sup>15</sup> Ownership concentration *per se* may be efficient because the existence of large shareholders monitoring management reduces the agency problem between management and shareholders (Jensen and Meckling, 1976; Shleifer and Vishny, 1986). But large concentration comes at a cost because it creates another agency problem: the expropriation of minority shareholders by large ones. An additional cost of heavily concentrated ownership is that the core investors are not diversified.

<sup>16</sup> La Porta et al. (2000a) find that, for a cross-section of countries around the world, various measures of dividend payout ratios are lower in countries with poor investor protection than in countries with high investor protection. This evidence suggests that companies in countries with poor laws and poor enforcement of those laws do not build reputations by paying high dividends to their shareholders.

<sup>17</sup> See La Porta, López-de-Silanes, and Shleifer (2006); Djankov et al. (2006).

<sup>18</sup> To compute a rough proxy of truly external equity financing, we first need a measure of ownership concentration. We multiply the total market value of common stock of all publicly traded firms by the average fraction of the equity not held by the largest three investors (that is, the complement of the ownership variable already described). We scale the total market value of common stock by the fraction of equity held by minority shareholders to avoid overestimating the availability of external financing. For example, if 90 percent of a firm's equity is held by insiders, then the market capitalization of the whole firm gives a 10-fold overestimate of how much has actually been raised externally. Therefore, an alternative measure is the ratio of external (outside the control group) equity finance to GNP in each country. The results presented in the text hold for this corrected ratio as well.

<sup>19</sup> Note that there are only four countries in the Scandinavian family.

<sup>20</sup> See La Porta, López-de-Silanes, and Shleifer (1999).

<sup>21</sup> The paper is a cross-country study of nations in the region that uses data on stocks and ADRs from Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. Interday data (time, price, and volume) from over 1,400 tickers in about 1000 corporations were obtained from Bloomberg for 42 weekdays in late 2003. The database was completed using market data on best offers, changes at each point in time, highest bids, total volumes, ask prices, and so on.

<sup>22</sup> Tobin's  $q$  is a classic measure of valuation that results from dividing the market value of debt and equity by the book value.

<sup>23</sup> See Easterbrook and Fischel (1991).

<sup>24</sup> See Gompers, Ishii, and Metrick (2003); Klapper and Love (2002); Black, Jang, and Kim (2006a); Doidge, Karolyi, and Stulz (2007).

<sup>25</sup> See, for example, the Credit Lyonnais Securities Asia index used by Klapper and Love (2002).

<sup>26</sup> Endogeneity is certainly a concern in the chapters, as well as in other papers on firm-level practices. See, for example, Gompers, Ishii, and Metrick (2003); Klapper and Love (2002); Black, Jang, and Kim (2006).

<sup>27</sup> See Klapper and Love (2002).

<sup>28</sup> Jensen and Meckling (1976).

<sup>29</sup> See Demsetz and Lehn (1985); Morck, Shleifer, and Vishny (1989); La Porta et al. (2000b); Gompers, Ishii, and Metrick (2003).

<sup>30</sup> See Gompers, Ishii, and Metrick (2003); Klapper and Love (2002).

<sup>31</sup> Depository receipts are typically divided into two groups: (1) global depository receipts, which are programs established outside the United States; these depository receipts are often listed on other international exchanges; and (2) ADRs, which are depository receipt programs in the United States. Among ADRs, there are four basic types according to the level of disclosure and the capital-raising ability. Rule 144A ADRs, which have become more important since 2003, give access to the U.S. market, but without the full registration and compliance costs. These ADRs are designed for firms that seek private U.S. placements for qualified institutional buyers. They do not require reconciliation with the U.S. Generally Accepted Accounting Principles or full U.S. Securities and Exchange Commission disclosure. Level 1 ADRs trade over the counter, involve minimal disclosure to the Securities and Exchange Commission, and do not require reconciliation with the Generally Accepted Accounting Principles. Level 2 ADRs are used by firms that want to list on a U.S. exchange, but do not raise new capital. Level 3 ADRs are used by firms that want to list on an exchange and do want to raise new capital. Levels 2 and 3 require large amounts of disclosure—similar, but not identical to U.S. firms—and GAAP reconciliation.

<sup>32</sup> See Merton (1987).

<sup>33</sup> See Poterba and Warshawsky (1999).

<sup>34</sup> See Coffee (1999); La Porta et al. (2003).

<sup>35</sup> See Coffee (1999).

<sup>36</sup> Basically, all Chilean and Mexican companies and the vast majority of Brazilian and Venezuelan firms choose to cross-list in the United States. The second market for Latin American cross-listings is Luxembourg, which attracts a handful of Argentine and Brazilian firms and a large proportion of the few Colombian cross-listers.

<sup>37</sup> Calculations based on data of the Bank of New York, <http://www.bankofny.com/>.

<sup>38</sup> Calculations based on data of the Bank of New York, <http://www.bankofny.com/>.

<sup>39</sup> See Moel and Tufano (2002).

<sup>40</sup> See La Porta et al. (1997, 1998); La Porta, López-de-Silanes, and Shleifer (2002); Doidge et al. (2004, 2005).

<sup>41</sup> See Doidge (2004) and Doidge, et al. (2005).

<sup>42</sup> See Zingales (2007).

<sup>43</sup> These three figures reflect the most updated data with consistent definitions across time. The data have been obtained by calculating the proportion of firms in the Standard & Poor's–International Finance Corporation Global index (which includes the largest and most visible firms in each country) that have ADRs in the United States.

<sup>44</sup> See Moel (2001).

<sup>45</sup> See Levine and Schmukler (2005).

<sup>46</sup> See Karolyi (2005).

<sup>47</sup> Moel (2001) and Haguis and Ramanlal (1998) focus on Latin American markets. Claessens, Klingsgebiel, and Schmuckler (2006) and Karolyi (2005) look at larger samples of countries and firms.

<sup>48</sup> See Karolyi (2005).

<sup>49</sup> See La Porta, López-de-Silanes, and Shleifer (2006); Djankov et al. (2006).

<sup>50</sup> See López-de-Silanes (1997).

<sup>51</sup> See López-de-Silanes and Zamarripa (1995); La Porta, López-de-Silanes, and Zamarripa (2003).

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**Table 1.**  
**Shareholder Protections in the 1990s**

<i>Country</i>	<i>Proxy by mail allowed</i>	<i>Shares not blocked</i>	<i>Cumulative vote, proportional representation</i>	<i>% capital to call ESM</i>	<i>Preemptive rights</i>	<i>Oppressed minority</i>	<i>Anti-directors rights</i>
<i>Shareholder rights (1 = investor protection is in the law)</i>							
<i>Panel A: Shareholders rights in 1995</i>							
Common law average	0.39	1.00	0.28	0.09	0.44	0.94	4.00
Argentina	0.00	0.00	1.00	0.05	1.00	1.00	4.00
Brazil	0.00	1.00	0.00	0.05	0.00	1.00	3.00
Chile	0.00	1.00	1.00	0.10	1.00	1.00	5.00
Colombia	0.00	1.00	1.00	0.25	1.00	0.00	3.00
Ecuador	0.00	1.00	0.00	0.25	1.00	0.00	2.00
Mexico	0.00	0.00	0.00	0.33	1.00	0.00	1.00
Peru	0.00	1.00	1.00	0.20	1.00	0.00	3.00
Uruguay	0.00	0.00	0.00	0.20	1.00	1.00	2.00
Venezuela, R. B. de	0.00	1.00	0.00	0.20	0.00	0.00	1.00
Latin American average	0.00	0.67	0.44	0.18	0.78	0.44	2.67
Rest of French-origin average	0.08	0.50	0.17	0.12	0.50	0.17	2.08
French-origin average	0.05	0.57	0.29	0.15	0.62	0.29	2.33
German-origin average	0.00	0.17	0.33	0.05	0.33	0.50	2.33
Scandinavian-origin average	0.25	1.00	0.00	0.10	0.75	0.00	3.00
Civil law average	0.18	0.71	0.27	0.11	0.53	0.53	2.65
World average	0.18	0.71	0.27	0.11	0.53	0.53	2.65
<i>Panel B: Shareholders rights in 1999</i>							
Common law average	0.40	1.00	0.30	0.09	0.40	0.95	4.00
Argentina	0.00	0.00	1.00	0.05	1.00	1.00	4.00
Bolivia	0.00	0.00	0.00	0.20	1.00	0.00	1.00
Brazil	0.00	1.00	0.00	0.05	0.00	1.00	3.00
Chile	0.00	1.00	1.00	0.10	1.00	1.00	5.00
Colombia	0.00	1.00	1.00	0.25	1.00	0.00	3.00
Costa Rica	0.00	0.00	1.00	0.25	0.00	0.00	1.00
Dominican Republic	0.00	1.00	0.00	0.25	0.00	1.00	3.00
Ecuador	0.00	0.00	0.00	0.25	1.00	0.00	1.00
El Salvador	0.00	0.00	0.00	0.05	0.00	0.00	1.00
Guatemala	0.00	0.00	1.00	0.25	0.00	0.00	1.00
Honduras	0.00	0.00	0.00	0.25	1.00	0.00	1.00
Mexico	0.00	0.00	0.00	0.33	1.00	0.00	1.00
Panama	0.00	0.00	1.00	0.05	0.00	0.00	2.00
Paraguay	0.00	0.00	0.00	0.05	0.00	1.00	2.00
Peru	0.00	1.00	1.00	0.20	1.00	0.00	3.00
Uruguay	0.00	0.00	0.00	0.20	1.00	1.00	2.00
Venezuela, R. B. de	0.00	1.00	0.00	0.20	0.00	0.00	1.00
Latin American average	0.00	0.35	0.41	0.18	0.53	0.35	2.06
Rest of French-origin average	0.09	0.45	0.18	0.13	0.45	0.18	2.00
French-origin average	0.03	0.41	0.31	0.15	0.52	0.28	2.07
German-origin average	0.00	0.17	0.33	0.05	0.33	0.50	2.33
Scandinavian-origin average	0.25	1.00	0.00	0.10	0.75	0.00	3.00
Civil law average	0.05	0.43	0.28	0.13	0.51	0.29	2.21
World average	0.17	0.63	0.29	0.12	0.47	0.51	2.80

*Sources:* Panel A: La Porta et al. 1998; Panel B: López-de-Silanes 2003.

*Note:* This Table classifies countries by legal origin. Definitions for each of the variables may be found in Annex 1. Panel A includes data for 42 countries. Panel B has data on 59 countries.

**Table 2.**  
**Enforcement of Laws in the 1990s**

<i>Country</i>	<i>Efficiency of judicial system</i>	<i>Rule of law</i>	<i>Corruption</i>	<i>Accounting standards</i>	<i>Court formalism to collect bounced check</i>
Common Law Average	8.10	6.10	6.46	69.62	2.76
Argentina	6.00	5.36	6.01	45.00	5.40
Bolivia		1.32	1.68		5.75
Brazil	5.75	6.31	6.31	54.00	3.06
Chile	7.25	7.02	5.30	52.00	4.57
Colombia	7.25	2.08	5.00	50.00	4.11
Costa Rica		6.67	8.33		5.48
Dominican Republic	6.75	3.14	3.00		4.08
Ecuador	6.25	6.67	5.18		4.92
El Salvador		2.38	3.69		4.60
Guatemala		1.43	2.00		5.68
Honduras		2.07	2.00		4.90
Mexico	6.00	5.36	4.76	60.00	4.71
Panama	6.75	2.11	2.11		5.84
Paraguay		4.11	2.14		5.91
Peru	6.75	2.50	4.70	38.00	5.60
Uruguay	6.50	5.00	5.00	31.00	4.05
Venezuela, R. B. de	6.50	6.37	4.70	40.00	6.01
Latin American average	6.52	4.11	4.23	46.25	4.98
Rest of French-origin average	6.62	6.38	5.95	55.10	3.78
French origin-average	6.57	5.05	4.94	51.17	4.29
Socialist-origin average	8.90	8.11	7.57	62.67	3.93
German-origin average	10.00	10.00	10.00	74.00	3.15
Scandinavian-origin average	7.36	6.03	5.86	56.89	3.15
Civil law average	7.65	6.05	6.07	60.93	3.38
World average	8.10	6.10	6.46	69.62	3.53

*Sources:* La Porta et al. 1997, 1998; Djankov et al. 2003; López-de-Silanes 2003.

*Note:* This Table classifies countries by legal origin. Definitions for each of the variables may be found in Annex 1. Data are available on 49 countries for all variables except the “Court formalism to collect bounced checks,” which is available for 109 countries.

**Table 3.**  
**Legal Reforms in Latin America**

<i>Reform</i>	<i>Argentina</i>	<i>Brazil</i>	<i>Chile</i>	<i>Colombia</i>	<i>Mexico</i>	<i>Venezuela, R. B. de</i>
New code of commerce, corporation law	n.a.	n.a.	1981	1987	n.a.	1955
Partial reform of the code of commerce, corporation law	n.a.	1999	1989, 1994, 2000 <sup>a</sup>	1995, 1997	n.a.	n.a.
New security market law	n.a.	n.a.	1981	n.a.	2005	1975
Partial reform of the security market law	2004	1997, 2001	1989, 1994, 2000, <sup>a</sup> 2001	n.a.	2001	1988
Committee on corporate governance, code of best practices	n.a.	n.a.	X	n.a.	January 2000	n.a.

*Source:* Compiled by the authors.

*Note:* n.a. = not applicable.

a. This amendment was known as the corporate governance law (Law 19,705).

**Table 4.**  
**Shareholder Protections in 2005**

<i>Country</i>	<i>Vote by mail</i>	<i>Shares not deposited</i>	<i>Cumulative voting</i>	<i>Oppressed minority</i>	<i>Preemptive rights</i>	<i>Capital to call meeting</i>	<i>Anti-director index</i>
Common law average	0.76	1.00	0.10	0.90	0.52	0.09	4.19
Argentina	0	0	0	0	1	0.05	2.00
Bolivia	0	0	0	1	1	0.20	2.00
Brazil	1	0	1	1	1	0.05	5.00
Chile	0	1	1	0	1	0.10	4.00
Colombia	0	1	1	0	1	0.20	3.00
Ecuador	0	1	0	0	1	0.25	2.00
El Salvador	0	0	0	0	1	0.05	2.00
Mexico	0	1	0	0	1	0.10	3.00
Panama	0	0	0	0	1	0.05	2.00
Peru	0	1	1	0.5	1	0.05	3.50
Uruguay	0	0	0	0	1	0.20	1.00
Venezuela, R. B. de	0	1	0	0	0	0.20	1.00
Latin American average	0.08	0.50	0.33	0.21	0.92	0.13	2.54
Rest of French-origin average	0.30	0.50	0.35	0.33	0.90	0.10	3.13
French-origin average	0.22	0.50	0.34	0.28	0.91	0.11	2.91
German-origin average	0.29	0.43	0.29	0.32	0.71	0.06	3.04
Scandinavian-origin average	0.00	1.00	0.20	0.60	1.00	0.09	3.80
Civil law average	0.22	0.53	0.31	0.32	0.86	0.09	3.03
World average	0.38	0.67	0.25	0.49	0.76	0.09	3.37

*Source:* Djankov et al. 2006.

*Note:* This Table classifies countries by legal origin. Definitions for each of the variables may be found in Annex 1. Data are available for 72 countries.

**Table 5.**  
**Securities Laws in 2001**

<i>Country</i>	<i>Disclosure requirements</i>	<i>Liability standard</i>	<i>Public enforcement</i>
Common law average	0.78	0.58	0.62
Argentina	0.50	0.22	0.58
Brazil	0.25	0.33	0.58
Chile	0.58	0.33	0.60
Colombia	0.42	0.11	0.58
Ecuador	0.00	0.11	0.55
Mexico	0.58	0.11	0.35
Peru	0.33	0.66	0.78
Uruguay	0.00	0.11	0.57
Venezuela, R. B. de	0.17	0.22	0.55
Latin American average	0.31	0.24	0.57
Rest of French-origin average	0.55	0.49	0.51
French-origin average	0.45	0.39	0.53
German-origin average	0.60	0.42	0.25
Scandinavian-origin average	0.56	0.47	0.38
Civil law average	0.49	0.40	0.46
World average	0.60	0.47	0.52

*Source:* La Porta, et. al (2006).

*Note:* This Table classifies countries by legal origin. Definitions for each of the variables may be found in Annex 1. Data are available for 49 countries.

**Table 6.**  
**Anti-Self-Dealing Regulations in 2005**

<i>Country</i>	<i>Ex ante private control of self-dealing</i>	<i>Ex post private control of self-dealing</i>	<i>Anti-self-dealing index</i>	<i>Public enforcement index</i>
Common law average	0.34	0.45	0.40	0.33
Argentina	0.33	0.35	0.34	0.00
Brazil	0.22	0.33	0.27	0.50
Chile	0.50	0.75	0.63	1.00
Colombia	0.83	0.31	0.57	0.00
El Salvador	0.83	0.03	0.43	0.00
Mexico	0.19	0.15	0.17	0.50
Panama	0.17	0.15	0.16	0.00
Peru	0.25	0.65	0.45	0.25
Uruguay	0.08	0.28	0.18	0.50
Venezuela, R. B. de	0.08	0.10	0.09	0.00
Latin American average	0.35	0.31	0.33	0.28
Rest of French-origin average	0.36	0.55	0.45	0.50
French-origin average	0.35	0.48	0.42	0.43
German-origin average	0.44	0.69	0.57	0.52
Scandinavian-origin average	0.24	0.60	0.42	0.35
World average	0.36	0.52	0.44	0.41

*Source:* Djankov et al. 2006.

*Note:* This Table classifies countries by legal origin. Definitions for each of the variables may be found in Annex 1. Data are available for 72 countries.



**Table 7.**  
**Market Outcomes**

<i>Country</i>	<i>Stock market capitalization to GDP</i>	<i>Listed firms per million population</i>	<i>IPOs to GDP</i>	<i>Block premium</i>	<i>Ownership concentration</i>
Common Law Average	85.54	32.56	3.71	0.04	0.44
Argentina	58.08	3.10	0.56	0.12	0.53
Bolivia	15.59	3.17			
Brazil	38.35	2.48	0.05	0.49	0.57
Chile	89.70	16.72	0.51	0.15	0.45
Colombia	14.27	2.89	0.01	0.15	0.63
Ecuador	5.77	2.38	0.00		0.54
El Salvador	17.26	5.62			
Mexico	21.87	1.73	0.22	0.47	0.64
Panama	25.21	9.68			
Peru	22.85	8.17	0.04	0.17	0.56
Uruguay	1.21	4.37	0.00		0.78
Venezuela, R. B. de	5.51	2.81	0.68	0.28	0.51
Latin American average	26.31	5.26	0.23	0.26	0.58
Rest of French-origin average	51.35	28.18	2.86	0.08	0.54
French-origin average	41.96	19.59	1.73	0.16	0.55
German-origin average	48.95	24.22	4.81	0.15	0.34
Scandinavian-origin average	90.37	69.40	3.38	0.02	0.37
Civil law average	48.62	25.74	2.54	0.14	0.49
World average	59.39	27.73	2.97	0.11	0.47

*Sources:* Djankov et al. 2006; Dyck and Zingales 2004.

*Note:* This Table classifies countries by legal origin. Definitions for each of the variables may be found in Annex 1. Data are available for 72 countries.

**Table 8.**  
**Regressions of External Financing in the Mid-1990s and Legal Origin**

<i>Independent variables</i>	<i>Dependent variables</i>		
	<i>Ratio: external cap to GNP</i>	<i>Ratio: domestic firms to population</i>	<i>Ratio: IPOs to population</i>
GNP per capita growth	3.6913 (4.7899)	4.5809 (2.8052)	0.4554 (0.4242)
Log GNP	9.0294 (4.1605)**	-0.9642 (1.8683)	0.1074 (0.1820)
Rule of law	5.2318 (2.0867)**	3.6805 (1.3250)***	0.3558 (0.1026)***
French origin, Latin America	-29.7382 (10.2542)***	-19.2761 (6.9754)***	-1.0812 (0.4395)**
Rest of French origin	-36.6155 (14.8308)**	-22.6474 (9.3752)**	-1.2178 (0.7977)
German origin	-28.5638 (18.7438)	-27.3288 (11.2920)**	-2.6202 (1.0341)**
Scandinavian origin	-1.1080 (36.6125)	-13.4163 (10.8309)	-0.2844 (1.4286)
Constant	-82.7251 (40.0524)**	13.3160 (19.9450)	-1.9039 (1.5455)
Observations	56	58	58
Adjusted R <sup>2</sup>	0.49	0.42	0.43

*Sources:* Data from La Porta et al. 1997, 1998; López-de-Silanes 2003.

*Note:* Ordinary least square regressions of a cross-section of 58 countries around the world. The dependent variables are (1) the ratio of external cap to GNP, (2) the ratio of domestic firms to population, and (3) the ratio of IPOs to population. The independent variables are (1) GNP per capita growth, (2) log GNP, (3) the rule of law, (4) Latin American–French origin, (5) rest of French origin, (6) German origin, and (7) Scandinavian origin. Robust standard errors are shown in parentheses.

\* significant at 10 percent. \*\* significant at 5 percent. \*\*\* significant at 1 percent.

**Table 9.**  
**Regressions of External Financing in**  
**Recent Years and Legal Origin**

<i>Independent variables</i>	<i>Dependent variables</i>		
	<i>Ratio: stock market capitalization to GDP</i>	<i>Listed firms per million population</i>	<i>Ratio: IPOs to GDP</i>
Log (GDP per capita)	25.6852 (5.35)***	10.0117 (3.32)***	1.3024 (4.76)***
Log (days to collect a check)	-11.3424 (1.39)	5.0761 (1.03)	0.6597 (1.04)
Latin American–French legal origin	-51.6098 (3.62)***	-30.2312 (4.50)***	-3.7450 (4.44)***
Rest of French legal origin	-39.1657 (2.48)**	-6.7395 (0.47)	-1.3616 (1.42)
German legal origin	-48.6178 (2.35)**	-23.0424 (2.44)**	-1.0043 (0.56)
Scandinavian legal origin	-50.7614 (1.45)	14.7840 (0.44)	-2.7117 (1.86)*
Constant	-65.7859 (1.32)	-73.7803 (2.40)**	-10.5211 (2.38)**
Observations	71	71	49
R-squared	0.46	0.22	0.46

*Sources:* Djankov et al. 2003, 2006.

*Note:* Ordinary least square regressions of a cross-section of 72 countries around the world. The dependent variables are (1) the ratio of stock market capitalization to GDP, (2) listed firms per million population, and (3) the ratio of IPOs to GDP. The independent variables are (1) the log of GDP per capita, (2) the log number of days to collect a bounced check, (3) Latin American–French origin, (4) rest of French origin, (5) German origin, and (6) Scandinavian origin. Robust t-statistics are shown in parentheses.

\* significant at 10 percent. \*\* significant at 5 percent. \*\*\* significant at 1 percent.

**Table 10.**  
**Regressions of External Financing in the Mid-1990s and**  
**Investor Protection Indicators**

<i>Independent variables</i>	<i>Dependent variables</i>		
	<i>Ratio: external cap to GNP</i>	<i>Ratio: domestic firms to population</i>	<i>Ratio: IPOs to population</i>
GDP growth	2.0931 (4.0054)	4.1525 (2.7734)	0.3948 (0.4171)
Log GNP	4.9795 (3.5746)	-3.1838 (1.6264)*	-0.0989 (0.2081)
Rule of law	6.9628 (2.3713)***	4.0502 (1.0967)***	0.3797 (0.0965)***
Anti-director rights, 1995	11.9880 (3.8124)***	5.7608 (2.3183)**	0.4347 (0.1555)***
Constant	-95.4152 (32.5668)***	7.7958 (15.0785)	-1.6353 (0.1555)***
Observations	56	58	58
Adjusted R <sup>2</sup>	0.49	0.35	0.39

*Sources:* Data from La Porta et al. 1997, 1998; López-de-Silanes 2003.

*Note:* Ordinary least squares regressions of a cross-section of 58 countries around the world. The dependent variables are (1) the ratio of external cap to GNP, (2) the ratio of domestic firms to population, and (3) the ratio of IPOs to population. The independent variables are (1) GDP growth, (2) the log of GNP, (3) the rule of law, (4) Anti-directors rights, and (5) creditor rights. Robust standard errors are shown in parentheses.

\* significant at 10 percent. \*\* significant at 5 percent. \*\*\* significant at 1 percent.

**Table 11.**  
**Regressions of External Financing in Recent Years and**  
**Investor Protection Indicators**

<i>Independent variables</i>	<i>Dependent variable: ratio of stock market capitalization to GDP</i>						
Log (GDP per capita)	18.0808 (3.49)***	22.3815 (5.21)***	17.3902 (3.52)***	16.6213 (3.40)***	20.9151 (5.08)***	19.5489 (3.60)***	23.4120 (5.08)***
Log (days to collect a check)	-24.8784 (2.33)**	-13.2081 (1.48)	-16.1920 (1.39)	-22.5142 (1.70)*	-11.3748 (1.66)	-32.7852 (2.70)***	-17.4775 (1.77)*
Anti-directors rights index 1995	14.3777 (2.58)**						
Anti-directors rights index 2005		10.0716 (1.82)*					
Disclosure requirements			104.7693 (4.02)***				
Liability standards				72.6623 (3.87)***			
Anti-self-dealing index					83.3342 (2.51)**		
Public enforcement of securities laws						91.8696 (2.07)**	
Public enforcement of anti-self-dealing							-14.9931 (1.02)
Constant	2.4870 (0.04)	-94.3833 (1.50)	-55.9920 (0.68)	12.1254 (0.15)	-94.3996 (2.01)**	26.0813 (0.32)	-40.6648 (0.67)
Observations	49	71	49	49	71	49	71
R-squared	0.40	0.39	0.43	0.39	0.45	0.41	0.37

*Sources:* La Porta et al. 1998; La Porta, López-de-Silanes, and Shleifer 2006; Djankov et al. 2003, 2006.

*Note:* Ordinary least squares regressions of a cross-section of 72 countries around the world. The dependent variable is stock market capitalization to GDP. The independent variables are (1) the log of GDP per capita, (2) the log number of days to collect a bounced check, (3) the anti directors rights index in 1995, (4) the anti directors rights index in 2005, (5) the disclosure requirements index, (6) the liability standards index, (7) the anti-self-dealing index, (8) the index on public enforcement of securities law, and (9) the index on public enforcement of self-dealing. Robust t-statistics are shown in parentheses.

\* significant at 10 percent. \*\* significant at 5 percent, \*\*\* significant at 1 percent.

**Table 12.**  
**External Finance, Legal Origins, and Investor Protection Indicators**

<i>Independent variables</i>	<i>Dependent variable: ratio of stock market capitalization to GDP</i>						
Log (GDP per capita)	19.8325 (3.76)***	25.6157 (5.35)***	19.3805 (3.60)***	19.5868 (3.47)***	23.9160 (5.18)***	19.3932 (3.96)***	26.1311 (5.25)***
Log (days to collect a check)	-19.9349 (1.64)	-10.7815 (1.33)	-16.7589 (1.29)	-19.1477 (1.38)	-9.3195 (1.32)	-24.9885 (2.02)**	-10.9255 (1.41)
Latin American–French legal origin	-33.4336 (2.44)**	-49.0001 (3.60)***	-9.7915 (0.45)	-31.6230 (1.94)*	-36.1878 (2.85)***	-40.2782 (2.84)***	-51.7290 (3.54)***
Rest of French legal origin	-11.1381 (0.65)	-37.2631 (2.57)**	-13.1866 (0.72)	-28.6891 (1.62)	-24.9001 (1.99)*	-21.2748 (1.31)	-37.6057 (2.47)**
German legal origin	-16.4804 (0.43)	-46.7572 (2.36)**	-18.9645 (0.48)	-26.9448 (0.67)	-35.9018 (2.37)**	0.2672 (0.01)	-47.0176 (2.36)**
Scandinavian legal origin	-26.6563 (0.60)	-49.9317 (1.44)	-17.4479 (0.40)	-31.8183 (0.73)	-34.5417 (1.03)	-14.9158 (0.36)	-49.2607 (1.45)
Anti-directors rights index 1995	11.5329 (2.23)**						
Anti-directors rights index 2005		1.7951 (0.40)					
Disclosure requirements			89.2059 (2.50)**				
Liability standards				53.1588 (2.21)**			
Anti–self-dealing index					45.5373 (1.43)		
Public enforcement of securities laws						93.6562 (1.97)*	
Public enforcement of anti–self-dealing							-10.8972 (0.84)
Constant	-16.9507 (0.24)	-75.5425 (1.33)	-52.4460 (0.62)	-3.5120 (0.04)	-91.5774 (2.04)**	-0.1578 (0.00)	-67.9709 (1.43)
Observations	49	71	49	49	71	49	71
R-squared	0.43	0.46	0.44	0.43	0.48	0.46	0.47

*Sources:* La Porta et al. 1998; La Porta, López-de-Silanes, and Shleifer 2006; Djankov et al. 2003, 2006.

*Note:* Ordinary least squares regressions of a cross-section of 72 countries around the world. The dependent variable is the ratio of stock market capitalization to GDP. The independent variables are (1) the log of (GDP per capita), (2) the log number of days to collect a bounced check, (3) Latin American–French origin, (4) rest of French origin, (5) German origin, (6) Scandinavian origin, (7) Anti-directors rights index in 1995, (8) Anti-directors rights index in 2005, (9) disclosure requirements index, (10) liability standards index, (11) anti–self-dealing index, (12) index of public enforcement of securities law, and (13) index of public enforcement of self-dealing. Robust t-statistics are shown in parentheses.

\* significant at 10 percent. \*\* significant at 5 percent. \*\*\* significant at 1 percent.

**Table 13.**  
**Principal Components**

<i>Independent variables</i>	<i>Dependent variable: ratio of stock market capitalization to GDP</i>			
Log (GDP per capita)	18.3803 (3.40)***	22.1593 (3.94)***	16.9974 (3.41)***	21.5449 (3.64)***
Log (days to collect a check)	-14.1145 (1.13)	-20.8832 (1.78)*	-13.4440 (1.26)	-29.0926 (2.50)**
Latin American–French legal origin	-12.3913 (0.69)	-42.6415 (2.74)***		
Rest of French legal origin	-8.1814 (0.47)	-28.6989 (1.83)*		
German legal origin	-11.7500 (0.30)	-11.9889 (0.35)		
Scandinavian legal origin	-14.7112 (0.34)	-18.3806 (0.49)		
Principal component, private enforcement	13.2660 (2.77)***		15.7700 (3.59)***	
Principal component, public enforcement		-17.7094 (1.75)*		-18.2791 (1.75)*
Constant	-5.9628 (0.08)	6.9148 (0.09)	-4.2254 (0.06)	37.0918 (0.46)
Observations	49	49	49	49
R-squared	0.44	0.45	0.44	0.40

*Sources:* La Porta et al. 1998; La Porta, López-de-Silanes, and Shleifer 2006; Djankov et al. 2003, 2006.

*Note:* Ordinary least squares regressions of a cross-section of 49 countries around the world with all investor protection indicators. The dependent variable is the ratio of stock market capitalization to GDP. The independent variables are (1) the log of GDP per capita; (2) the log number of days to collect a bounced check; (3) Latin American–French origin; (4) rest of French origin; (5) German origin; (6) Scandinavian origin; (7) principal component of private enforcement variables: Anti-directors rights index, disclosure requirements index, liability standards index, and anti–self-dealing index; and (8) principal component of public enforcement variables: public enforcement of security laws and public enforcement of self-dealing. Robust t-statistics are shown in parentheses.

\* significant at 10 percent. \*\* significant at 5 percent. \*\*\* significant at 1 percent.

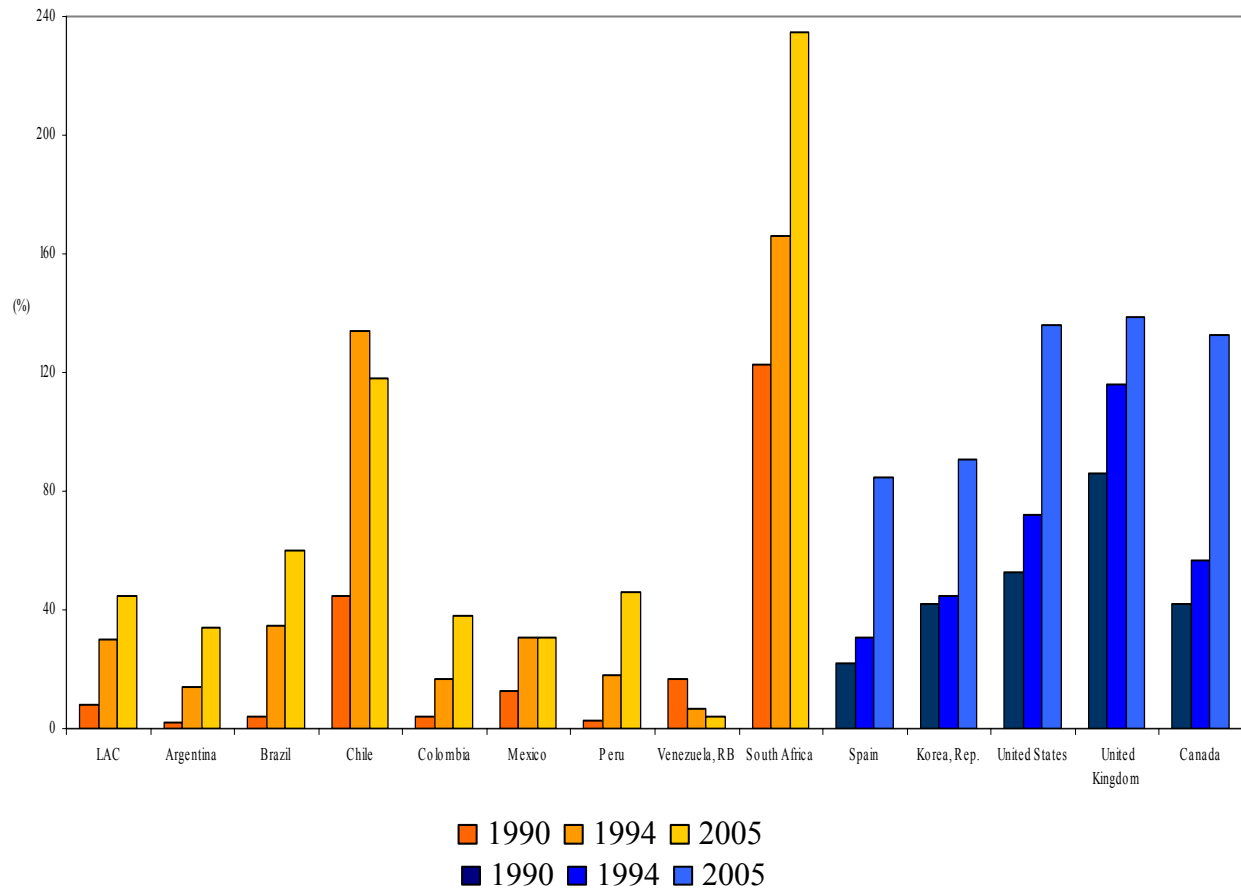
**Table 14.**  
**Questions in Each Category on the Corporate Governance Questionnaire**

<i>number</i>	<i>No. Question category</i>	<i>Argentina</i>	<i>Brazil</i>	<i>Chile</i>	<i>Colombia</i>	<i>Costa Rica</i>	<i>Mexico</i>	<i>Venezuela, R. B. de</i>
1	Company structure and governance characteristics	0	2	1	1	3	0	5
2	General governance principles	1	0	1	4	4	0	4
3	Board structure and board meetings	2	4	4	6	10	14	11
4	Board committees: structure and functions	4	2	3	0	6	20	4
5	External auditors and other independent experts	1	1	1	1	1	6	4
6	Financial disclosure	13	2	2	6	8	1	8
7	Conflicts of interest (related party transactions, ownership structure, compensation, and nomination)	11	7	4	8	13	5	13
8	Shareholders rights and meetings	0	3	3	5	15	8	16
9	Sanctions and recent governance problems	0	3	1	0	5	0	5
	Corporate governance index	32	24	20	31	65	54	70

*Source:* Chapters in this volume.

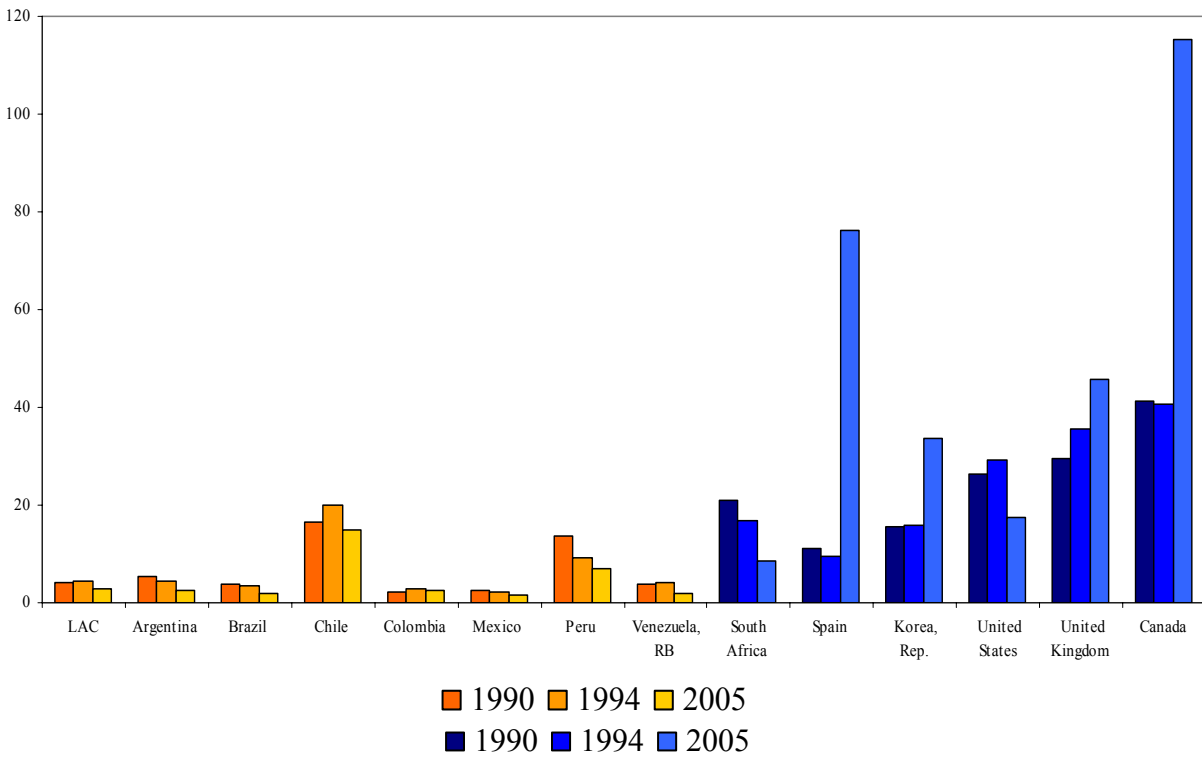


**Figure 1.**  
**Market Capitalization Relative to GDP, 1990, 1994, 2004**



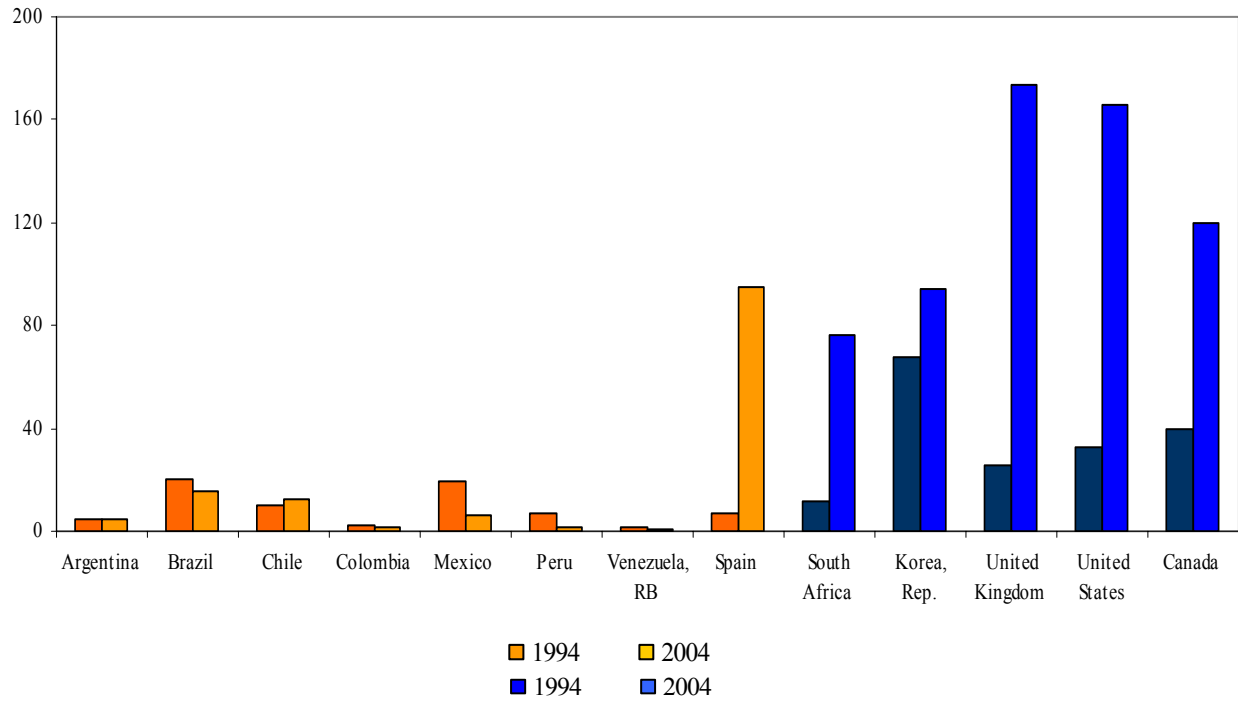
Source: World Bank 2006.

**Figure 2.**  
**Listed Companies, 1990, 1994, 2004**



*Source: World Bank 2006.*

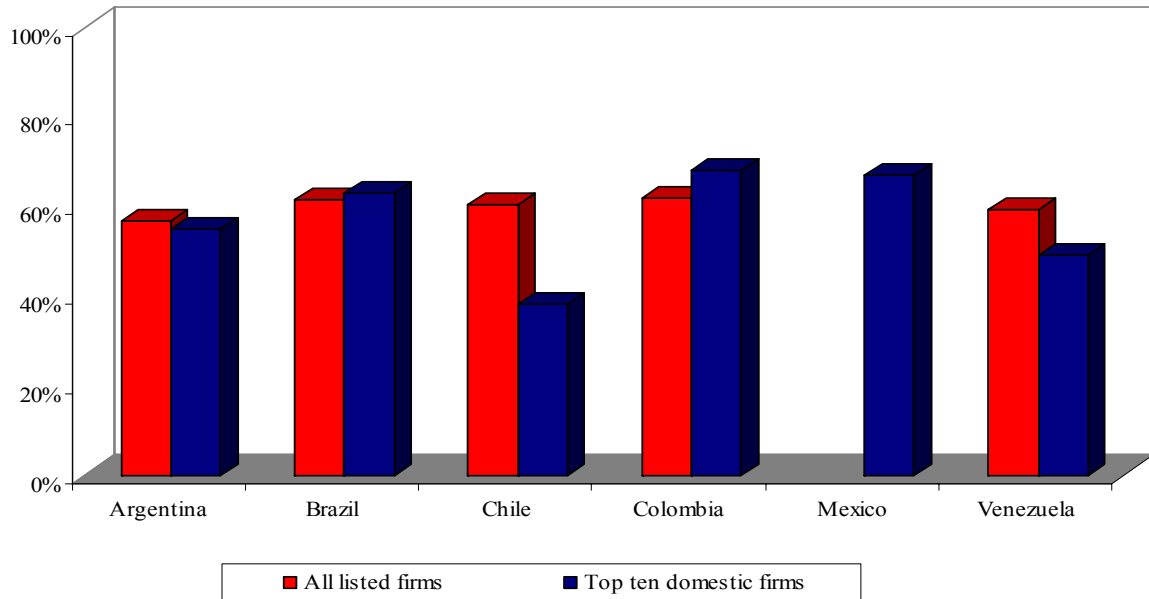
**Figure 3.**  
**Trading Value Relative to GDP, 1994 and 2004**



*Source:* Standard & Poor's 2005.

*Note:* The figure is based on the Standard & Poor's-International Finance Corporation Global index.

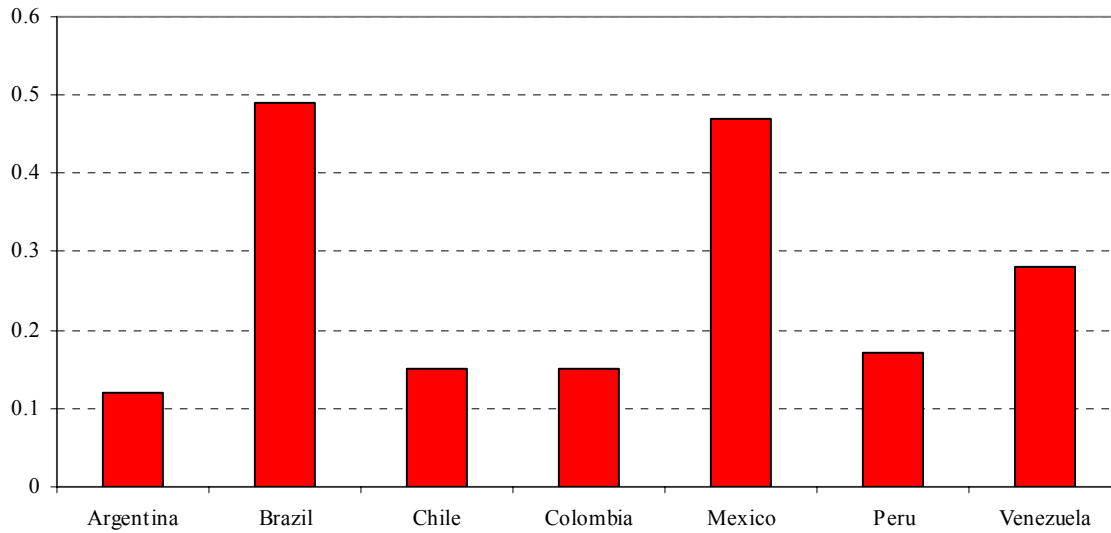
**Figure 4.**  
**The Concentration of the Cash Flow Rights of Controlling Groups**



*Source:* Data from La Porta et al. 1998.

*Note:* "All listed firms" refers to all firms included in the samples under analysis in this book. For Brazil, Chile, and Colombia, data refer to the cash flow rights of the three major shareholders. For Argentina, they refer to the main ultimate shareholder. For República Bolivariana de Venezuela, they refer to the share owned by the major stockholder. The columns for the top 10 domestic firms refer to the cash flow rights of the three largest shareholders.

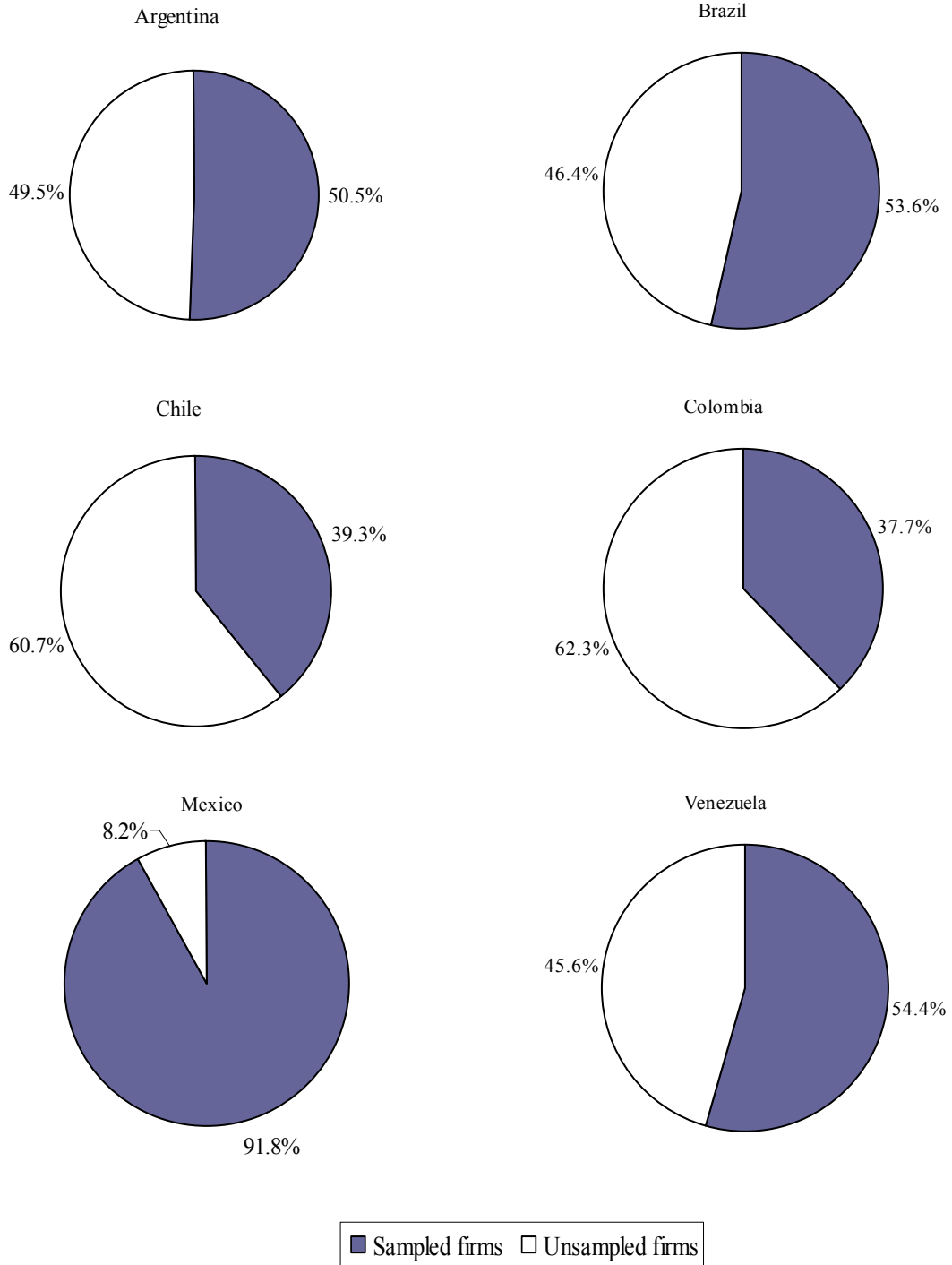
**Figure 5.**  
**Block Premiums Relative to Firm Equity**



*Source:* Dyck and Zingales 2004.

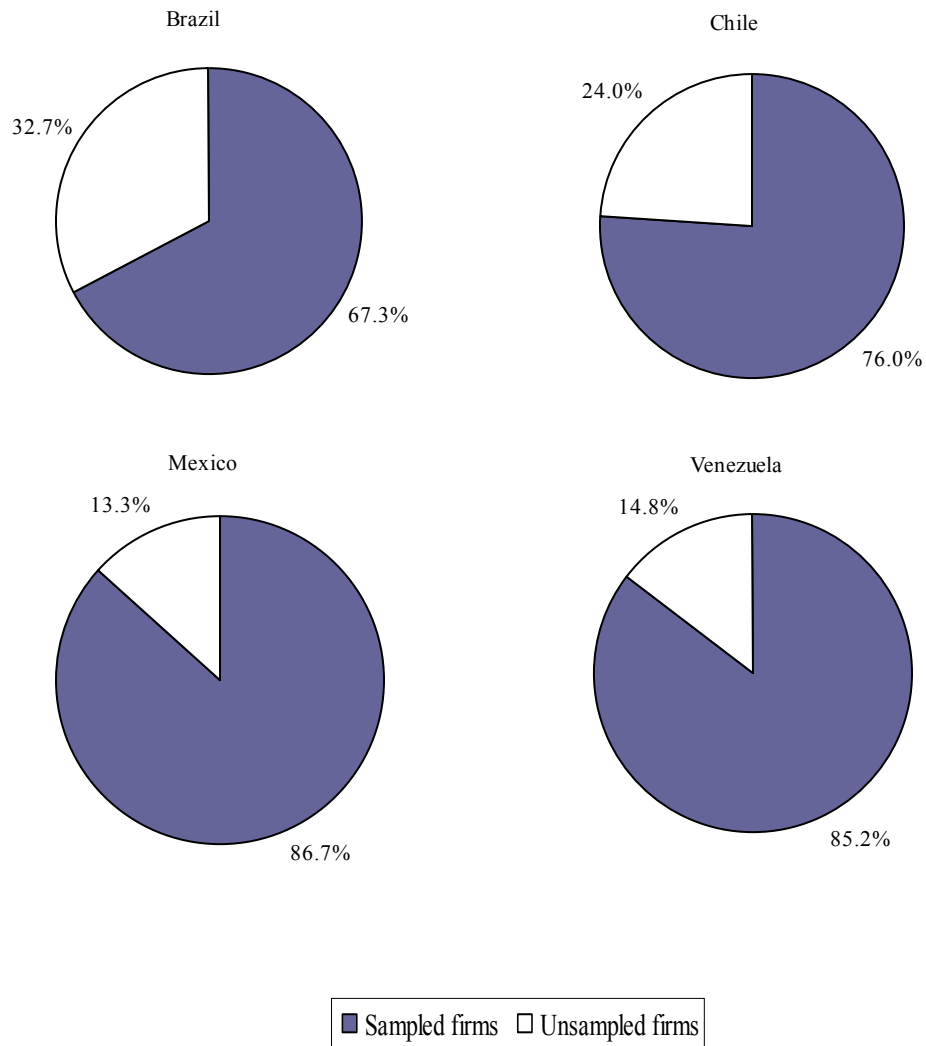
*Note:* The block premium is computed as follows: the difference between the price per share paid for the control block and the exchange price two days after the announcement of the control transaction is divided by the exchange price two days after the announcement. The result is multiplied by the proportion of cash flow rights represented in the controlling block.

**Figure 6**  
**Listed and Sampled Firms**



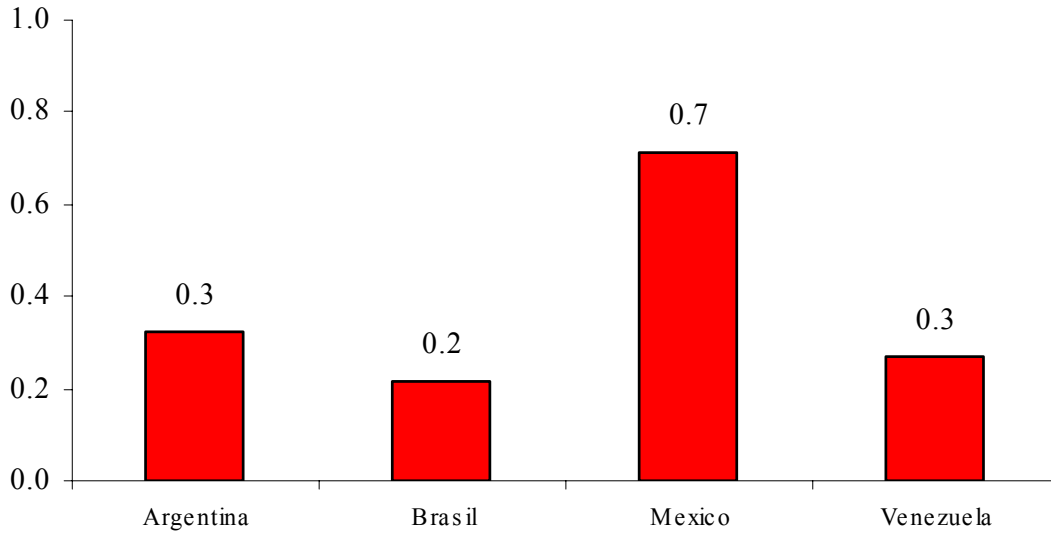
Source: Chapters included in this volume.

**Figure 7**  
**Market Capitalization of Listed Firms and Total Market Capitalization**



Source: Chapters in this volume.

**Figure 8**  
**The Effect of Corporate Governance on Tobin's q**

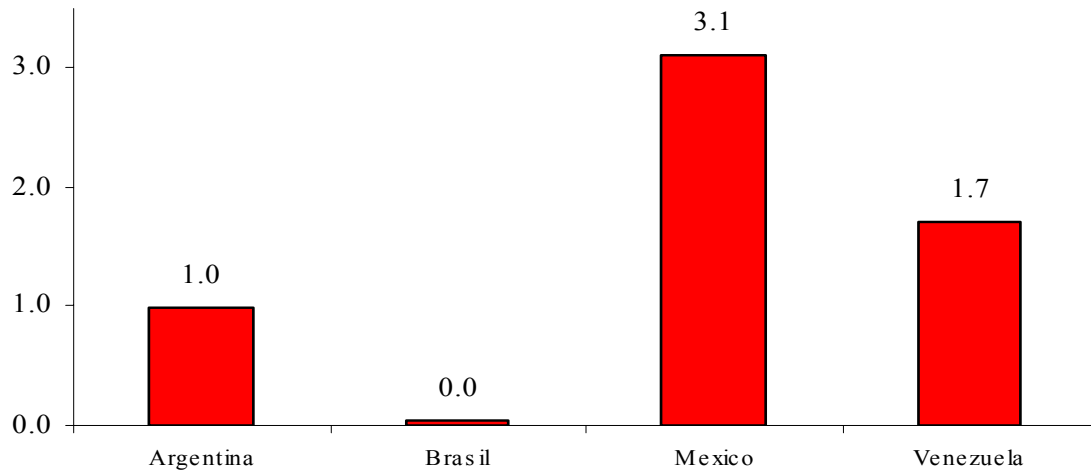


*Source:* Calculations of the authors based on the results of regression analyses discussed in the chapters.

*Note:* The figure shows the percentage increase in each country's Tobin's q caused by an increase in the corporate governance index of two standard deviations. The numbers for each country are not the result of the same calculation or methodology. Argentina uses the transparency and disclosure index instead of the corporate governance index, and the data cover the period 2000–03. The data on Brazil are for 2002, on Mexico for 2002–03, and on República Bolivariana de Venezuela for 2004. The results for this last country come from an ordinary least squares model. The coefficients for Brazil are estimated using a three-stage least squares model to deal with endogeneity problems. Argentina and Mexico use a two-stage least squares model to deal with endogeneity.



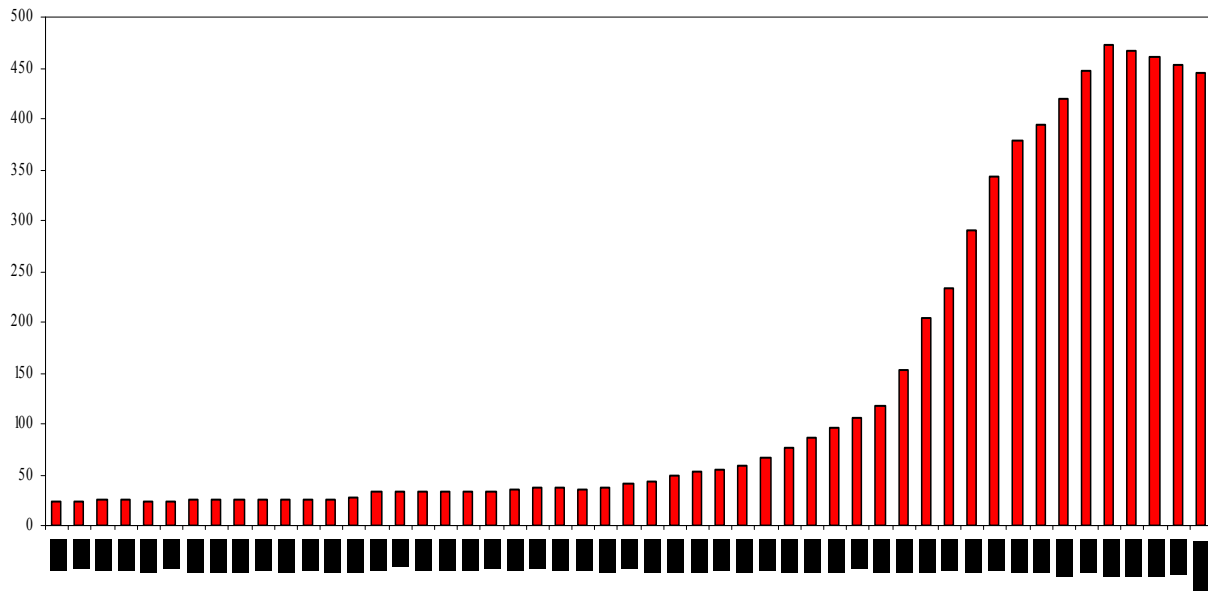
**Figure 9**  
**The Effect of Corporate Governance on Dividend Payout**



*Source:* Calculations of the authors based on the results of regression analyses discussed in the chapters.

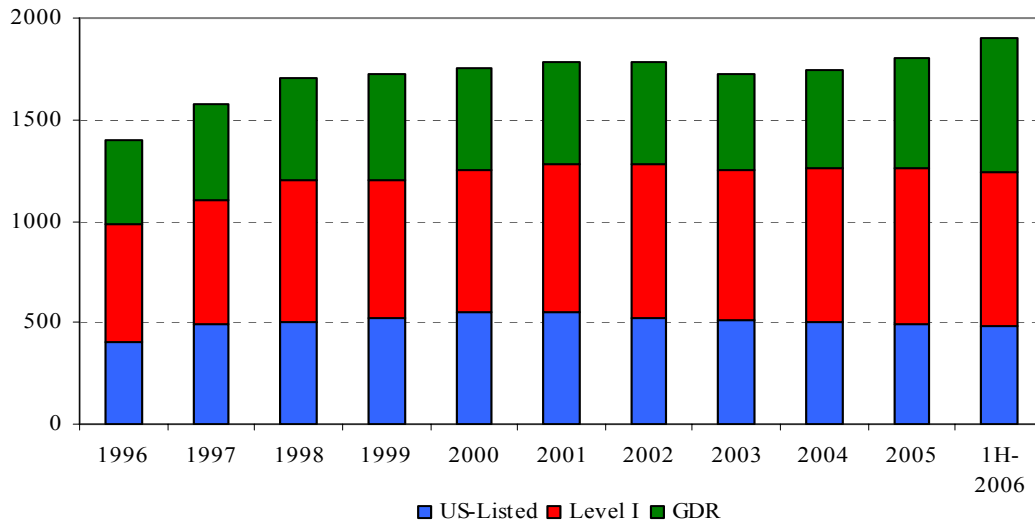
*Note:* The results are from regression analyses that are not strictly the same for each country. Argentina uses a pooled Tobit regression for the years 2000–03. To deal with potential endogeneity, Brazil uses a three-stage least squares model for 2002, and Mexico uses a two-stage least squares procedure for data from 2002–03. República Bolivariana de Venezuela, using data for 2004, estimates ordinary least squares models.

**Figure 10**  
**Non-U.S. Firms Cross-Listing on the New York Stock Exchange**



*Source:* Up to 2001: White 2002. After 2001: compiled by the authors from data provided by the New York Stock Exchange, <http://www.nyse.com/marketinfo/datalib/1022221393065.html>.

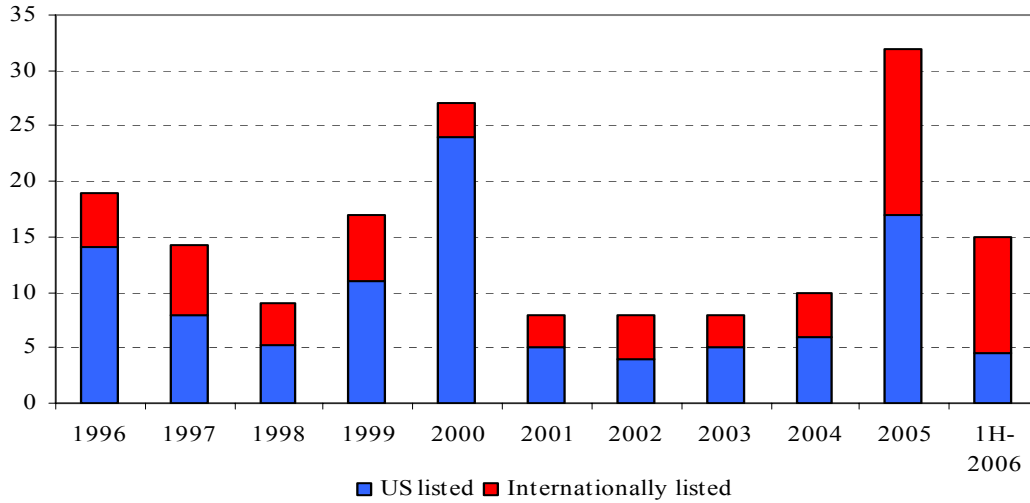
**Figure 11**  
**Sponsored Depository Receipt Programs**



*Source:* Comiled based on data in NYSE 2005, 2006.

*Note:* U.S.-listed stocks include level 2 and level 3 ADRs. Level 1 refers to over-the-counter ADRs. Global depository receipts are depository receipt programs that are established under private placement and non-U.S. offering rules and that are often listed on international stock exchanges. The data for 2006 correspond to data available until July 2006.

**Figure 12**  
**Annual Capital-Raising Value of Depository Receipts**

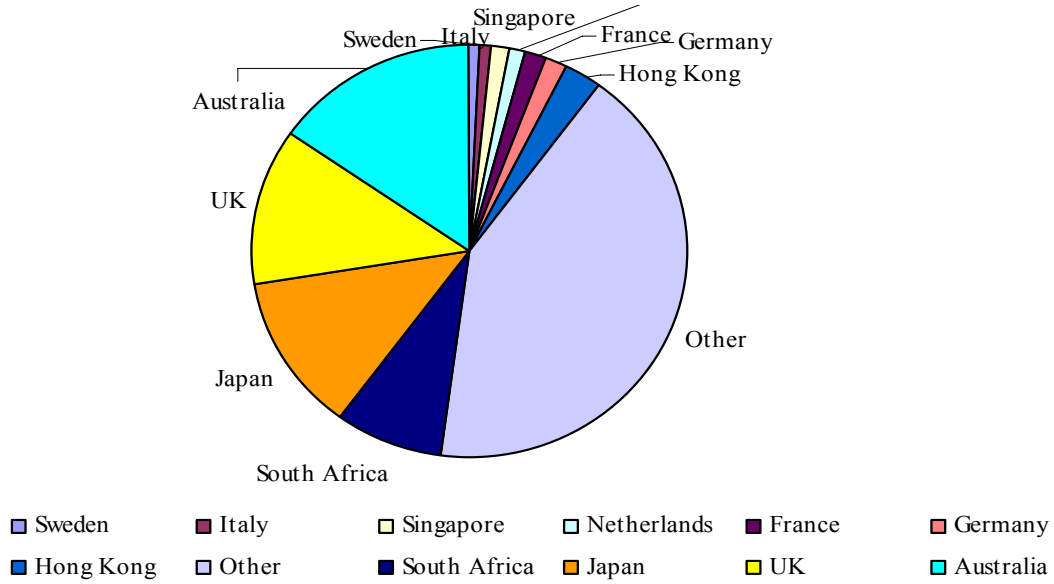


*Source:* Data from NYSE 2005, 2006.

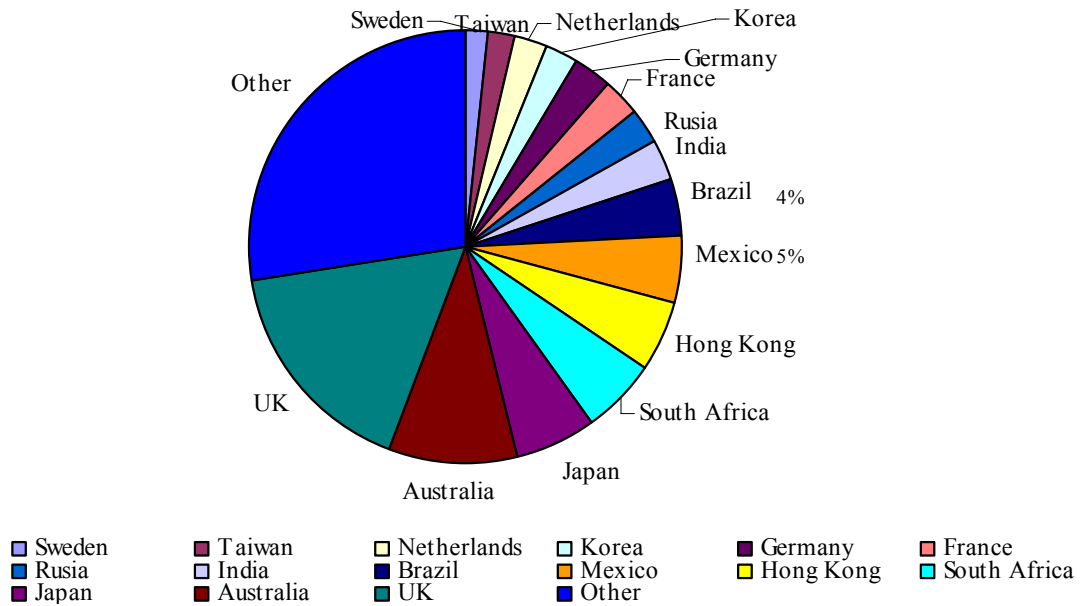
*Note:* U.S.-listed stocks include level 2 and level 3. Internationally listed stocks are those depository receipt programs listed in stock exchanges outside the United States. The data for 2006 correspond to data available up to July 2006.

**Figure 13**  
**Composition of ADR Listings in the United States**

**a. Composition in 1990**

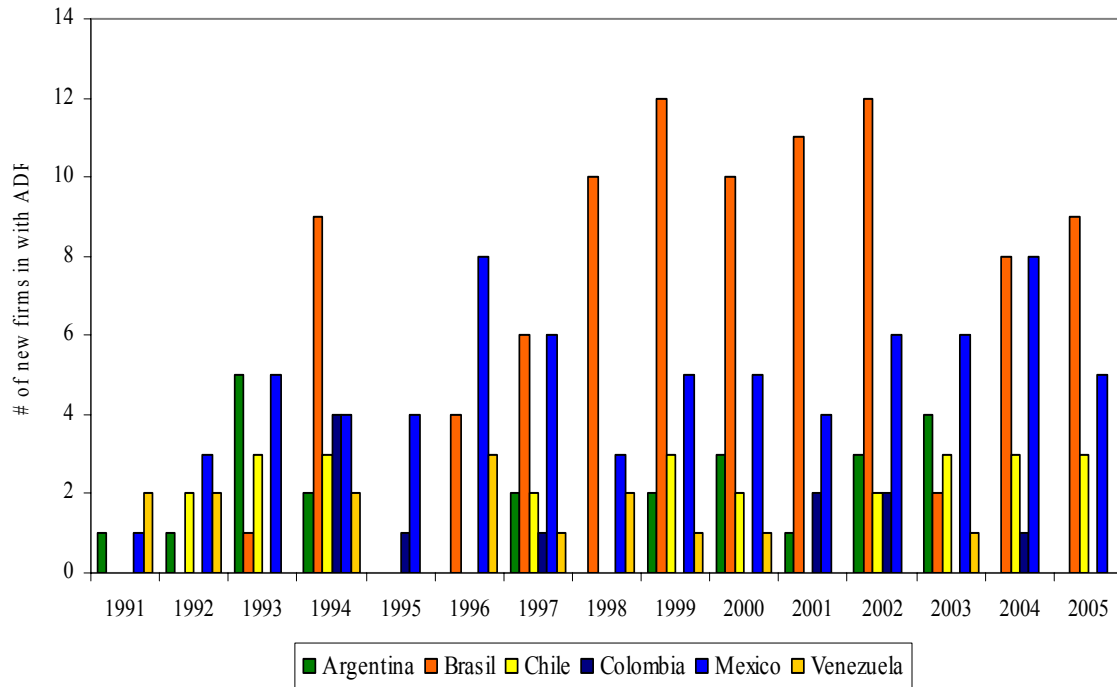


**b. Composition in 2003**



Source: Data from Karolyi 2005.

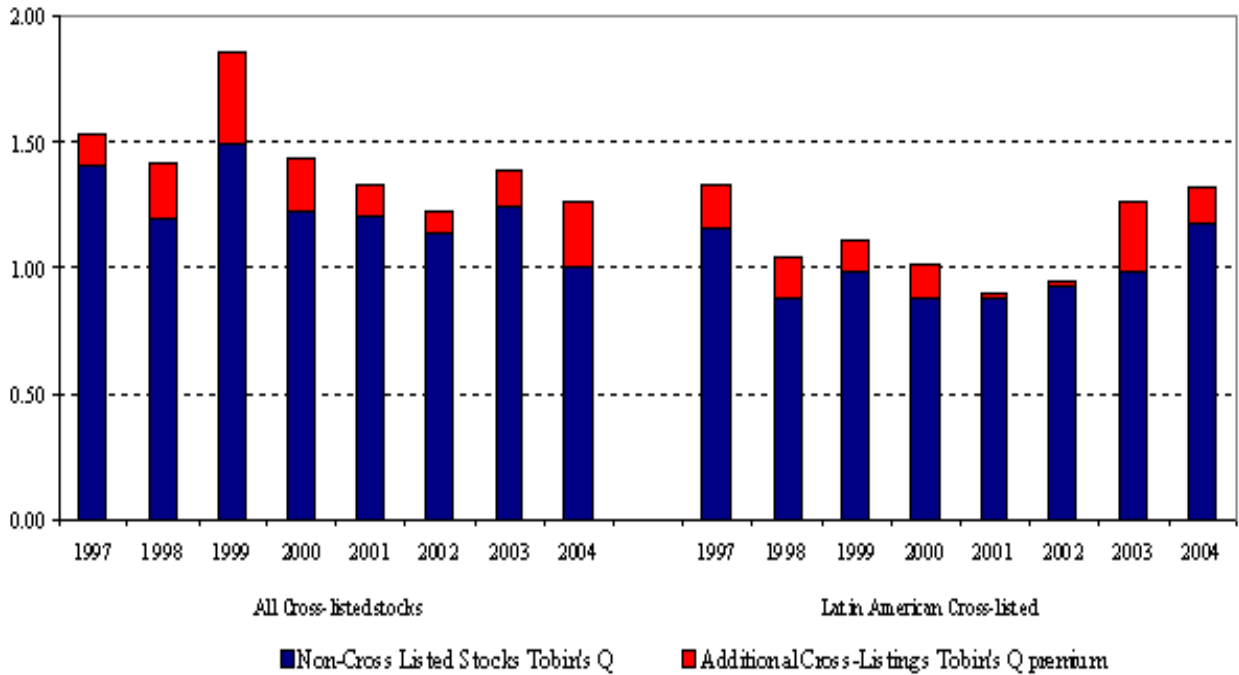
**Figure 14**  
**New Latin American Firms with ADRs**



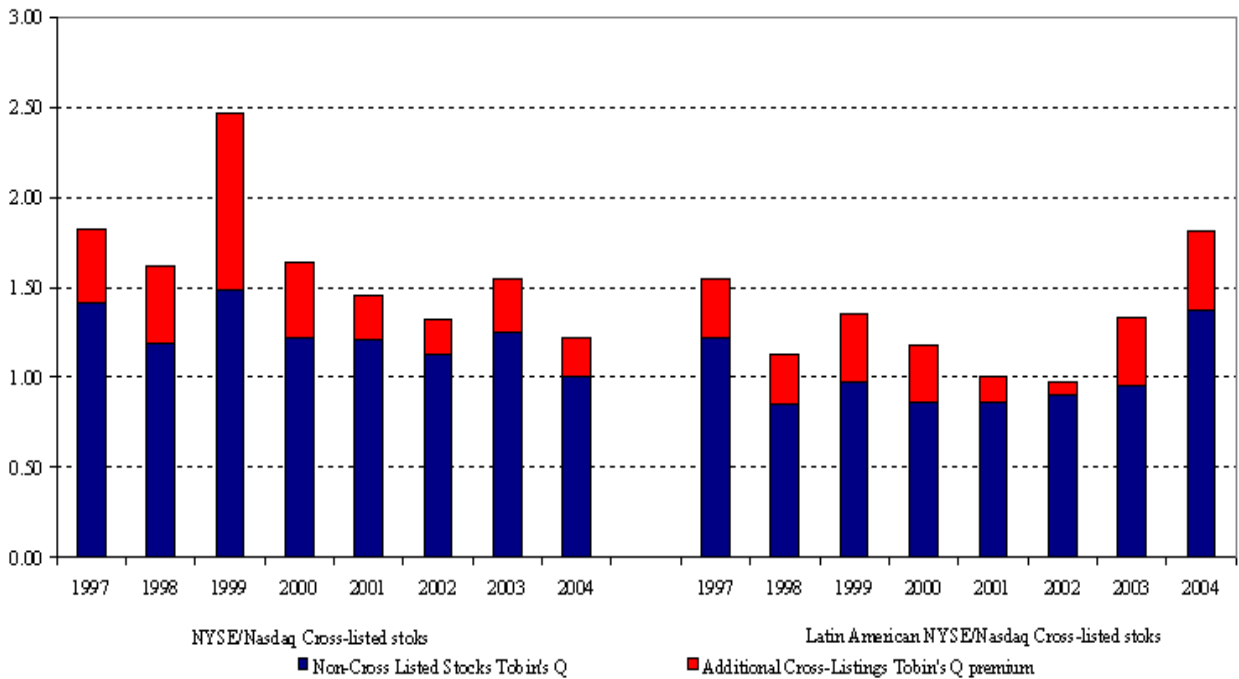
*Source:* Compiled by the authors based on data from the Bank of New York, <http://www.bankofny.com/>.

*Note:* The ADRs include all ADR levels, Rule 144A, and Reg S programs.

**Figure 15**  
**The Valuation Premiums of U.S. Cross-Listings**  
**All cross-listed stocks and Latin American cross-listed stocks**



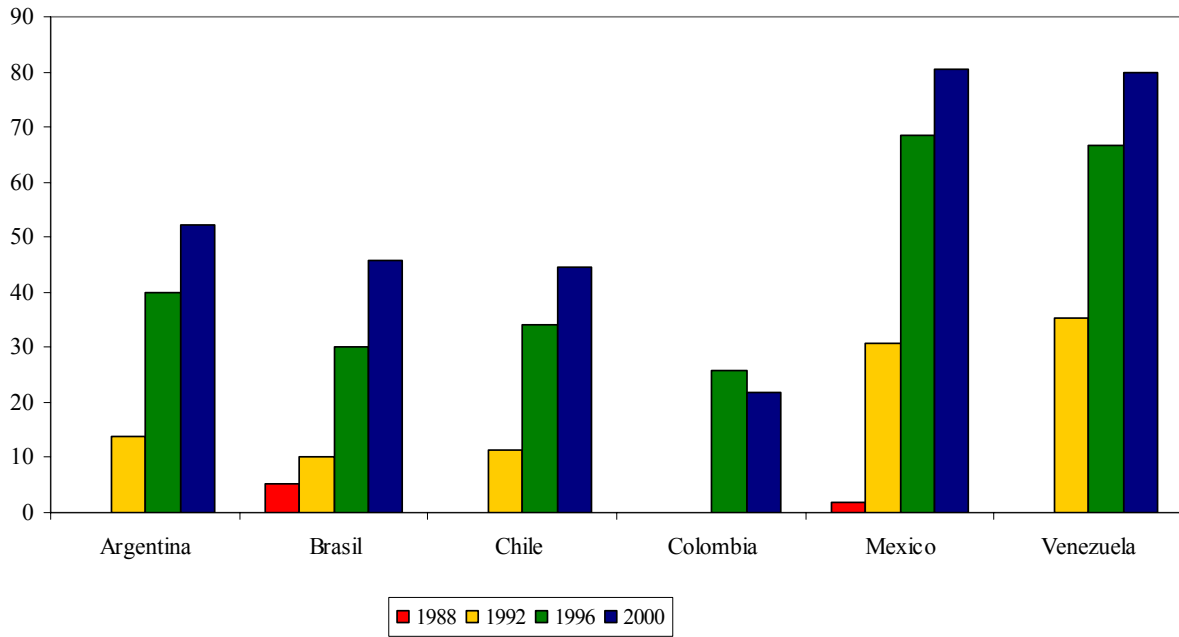
**Stocks cross-listed on the New York Stock Exchange and Nasdaq**



*Source:* Compiled by the authors based on data in Doige, Karolyi, and Stulz et al. 2005.

*Note:* Latin American countries include Argentina, Brazil, Chile, Colombia, Mexico, Peru, and República Bolivariana de Venezuela. There are no exchange-listed Colombian stocks in the sample used here; so, chart b has been elaborated without these stocks.

**Figure 16**  
**ADR Holders as a Share of Listed Firms**

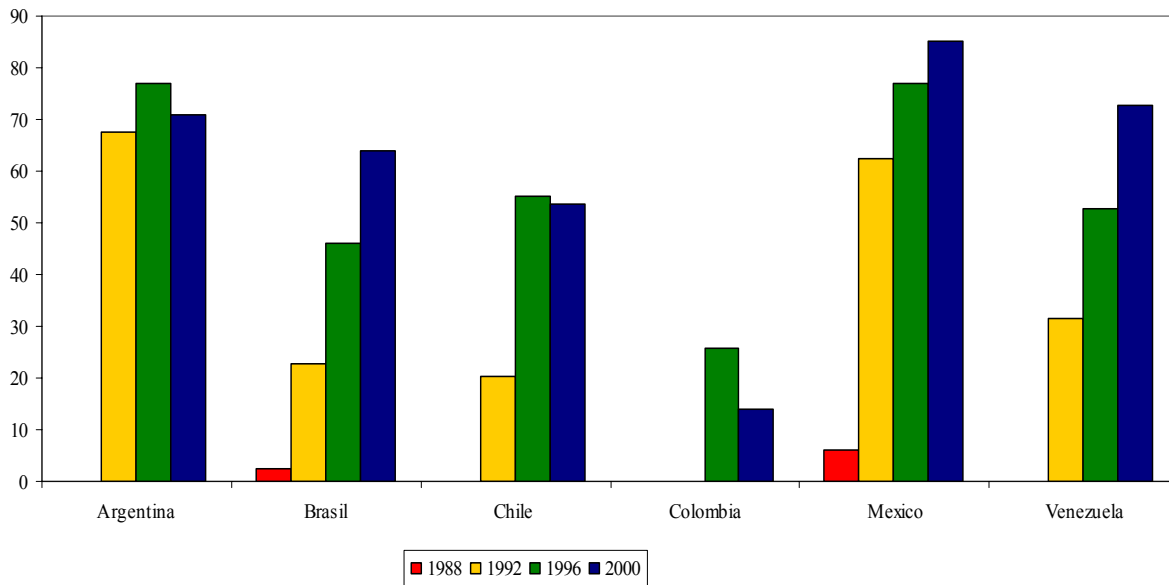


*Source:* Data from Karolyi 2004.

*Note:* The stocks for the domestic market are those included in the Standard & Poor's–International Finance Corporation Global index for each country.



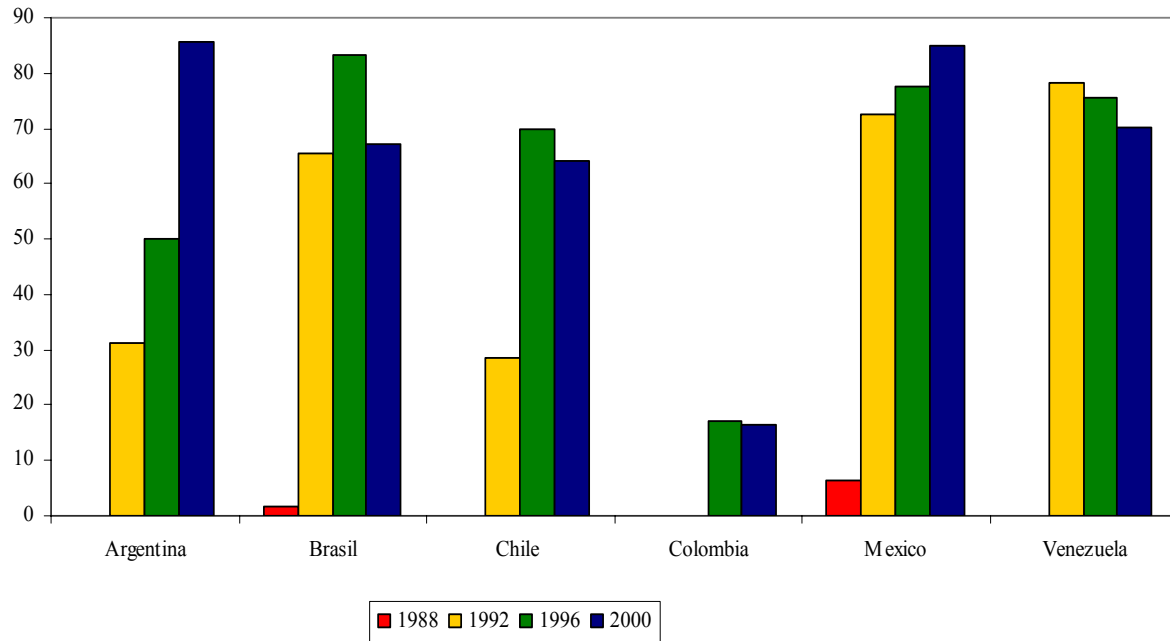
**Figure 17**  
**ADR Market Capitalization as a Share of Total Market Capitalization**



*Source:* Data from Karolyi 2004.

*Note:* The stocks for the domestic market are those included in the Standard & Poor's–International Finance Corporation Global index for each country.

**Figure 18**  
**ADR Value Traded as a Share of Total Value Traded**



*Source:* Data from Karolyi 2004.

*Note:* The stocks for the domestic market are those included in the Standard & Poor's–International Finance Corporation Global index for each country.

## Annex 1 Variable Definition

The Table below describes the variables collected for the 49 countries included in our study. The first column gives the name of the variable. The second column describes the variable and gives the range of possible values. The third column provides the sources from which the variable has been collected.

<i>Variable</i>	<i>Description</i>	<i>Sources</i>
Legal origin	Identifies the legal origin of the company law or commercial code of each country. Equals 1 if the origin is English Common Law, 2 if the origin is the French Commercial Code, and 3 if the origin is the German Commercial Code.	La Porta et al. (1998), collected from "Foreign Law Encyclopedia of Commercial Laws of the World."
Proxy by mail allowed	Equals 1 if the company law or commercial code allows shareholders to mail their proxy vote to the firm; zero otherwise.	La Porta et al. (1998).
Vote by mail	Equals 1 if the law explicitly mandates or sets as a default rule that: (1) proxy solicitations paid by the company include a proxy form allowing shareholders to vote on the items on the agenda, (2) a proxy form to vote on the items on the agenda accompanies notice to the meeting, or (3) shareholders vote by mail on the items on the agenda (that is, postal ballot); zero otherwise.	Djankov et al. (2006).
Shares not blocked	Equals one if the company law or commercial code does not allow firms to require that shareholders deposit their shares prior to a general shareholders meeting, thus preventing them from selling those shares for a number of days; zero otherwise.	La Porta et al. (1998).
Shares not deposited	Equals 1 if the law does not require, nor explicitly permits companies to require, shareholders to deposit with the company or another firm any of their shares prior to a general shareholders meeting.	Djankov et al. (2006).
Cumulative voting or proportional representation	Equals 1 if the company law or commercial code allows shareholders to cast all of their votes for one candidate standing for election to the board of directors (cumulative voting) or if the company law or commercial code allows a mechanism of proportional representation in the board by which minority interests may name a proportional number of directors to the board; zero otherwise.	La Porta et al. (1998); Djankov et al. (2006).
Capital to call a meeting	The minimum percentage of ownership of share capital that entitles a shareholder to call for an extraordinary shareholders meeting. It ranges from 1 to 33 percent.	La Porta et al. (1998); Djankov et al. (2006).
Preemptive rights	Equals 1 if the company law or commercial code grants shareholders the first opportunity to buy new issues of stock, and this right may only be waived by a shareholders vote; zero otherwise.	La Porta et al. (1998); Djankov et al. (2006).
Oppressed minorities	Equals 1 if the company law or commercial code grants minority shareholders either a judicial venue to challenge the decisions of management or of the assembly or the right to step out of the company by requiring the company to purchase their shares when they object to certain fundamental changes, such as mergers, assets dispositions, and changes in the articles of incorporation. The variable equals zero otherwise. Minority shareholders are defined as those shareholders who own 10 percent of share capital or less.	La Porta et al. (1998); Djankov et al. (2006).
Anti-directors rights index	An index aggregating the shareholder rights that we labeled "anti-directors rights." The index is formed by adding 1 when: (1) the country allows shareholders to mail their proxy vote to the firm, (2) shareholders are not required to deposit their shares prior to the general shareholders meeting, (3) cumulative voting or proportional representation of minorities in the board of directors is allowed, (4) an oppressed minorities mechanism is in place, (5) the minimum percentage of share capital that entitles a shareholder to call for an extraordinary shareholders meeting is less than or equal to 10 percent (the sample median), or (6) shareholders have preemptive rights that may only be waived by a shareholder vote. The index ranges from 0 to 6.	La Porta et al. (1998); Djankov et al. (2006).
Disclosure requirements index	The index of disclosure equals the arithmetic mean of (1) prospect, (2) compensation, (3) shareholders, (4) inside ownership, (5) contracts irregular, (6) and transactions.	La Porta, López-de-Silanes, and Shleifer (2006).
Liability standards index	The index of liability standards equals the arithmetic mean of (1) the liability standard for the issuer and its directors, (2) the liability standard for distributors, and (3) the liability standard for accountants.	La Porta, López-de-Silanes, and Shleifer (2006).
Public enforcement index	The index of public enforcement equals the arithmetic mean of (1) the supervisor characteristics index, (2) the rulemaking power index, (3) the investigative powers index, (4) the orders index, and (5) the criminal index.	La Porta, López-de-Silanes, and Shleifer (2006).
Ex ante private control of self-dealing	Index of ex ante control of self-dealing transactions. Average of approval by disinterested shareholders and ex ante disclosure.	Djankov et al. (2006).
Ex post private control of self-dealing	Index of ex post control over self-dealing transactions. Average of disclosure in periodic filings and ease of proving wrongdoing. Ranges from zero to 1.	Djankov et al. (2006).
Anti-self-dealing index	Average of ex ante and ex post private control of self-dealing.	Djankov et al. (2006).
Public enforcement of self-dealing	Index of public enforcement. Ranges from 0 to 1. One-quarter point when each of the following sanctions is available: (1) fines for the approving body, (2) jail sentences for the approving body, (3) fines for Mr. James, and (4) jail sentence for Mr. James.	Djankov et al. (2006).
Efficiency of judicial system	Assessment of the efficiency and integrity of the legal environment as it affects business, particularly foreign firms that is produced by the country-risk rating agency, Business International Corporation. It may be taken to represent investor assessments of conditions in the country in question. Average between 1980 and 1983. Scale from 0 to 10, with lower scores indicating lower efficiency levels.	La Porta et al. (1998).
Rule of law	Assessment of the law-and-order tradition in the country produced by the country-risk rating agency International Country Risk. Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores indicating less tradition for law and order. (We have changed the scale from its original range of 0 to 6.)	La Porta et al. (1998).

Corruption	International Country Risk's assessment of the corruption in government. Lower scores indicate high government officials are likely to demand special payments and illegal payments are generally expected throughout lower levels of government in the form of bribes connected with import and export licenses, exchange controls, tax assessment, policy protection, or loans. Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores indicating higher levels of corruption. (We have changed the scale from its original range of 0 to 6.)	La Porta et al. (1998).
Accounting standards	Index created by examining and rating the 1990 annual reports of companies on their inclusion or omission of 90 items. These items fall into seven categories (general information, income statements, balance sheets, funds flow statement, accounting standards, stock data, and special items). A minimum of three companies in each country have been studied. The companies represent a cross-section of various industry groups whereby industrial companies represented 70 percent, while financial companies represented the remaining 30 percent.	La Porta et al. (1998).
Court formalism to collect a bounced check	The index measures substantive and procedural statutory intervention in judicial cases at lower-level civil trial courts and is formed by adding up the following indicators: (1) professionals versus laymen, (2) written versus oral elements, (3) legal justification, (4) statutory regulation of evidence, (5) control of superior review, (6) engagement formalities, and (7) independent procedural actions. The index ranges from 0 to 7, where 7 means a higher level of control or intervention in the judicial process.	Djankov et al. (2003).
Stock market capitalization to GDP	Ratio of the market capitalization (also known as market value, which is the share price, multiplied by the number of shares outstanding) of listed domestic companies (the domestically incorporated companies listed on the country's stock exchanges at the end of the year) divided by the GDP (in millions).	La Porta et al. (1998) for Table II.6; World Bank (2005) for figure III.1.
Listed firms per million population	Ratio of the listed domestic companies are the domestically incorporated companies listed on the country's stock exchange at the end of the year relative to its population (in millions). (This indicator does not include investment companies, mutual funds, or other collective investment vehicles.)	La Porta et al. (1998) for Table II.6; World Bank (2005) for figure III.2.
IPOs to GDP	Average of the ratio of the equity issued by newly listed firms in a given country (in thousands) to its GDP (in millions) over the period 1996–2000.	La Porta et al. (2006).
Block premium	The block premium is computed taking the difference between the price per share paid for the control block and the exchange price two days after the announcement of the control transaction, divided by the exchange price and multiplying by the ratio of the proportion of cash flow rights represented in the controlling block. We use the country's sample media.	La Porta et al. (2006); taken from Dyck and Zingales (2004).
Ownership concentration	Average percentage of common shares not owned by the top three shareholders in the ten largest nonfinancial, privately owned domestic firms in a given country. A firm is considered privately owned if the State is not a known shareholder in it.	La Porta, López-de-Silanes, and Shleifer (1999); Hartland-Peel (1996) for Kenya; Bloomberg and various annual reports for Ecuador, Jordan, and Uruguay.
Trading volume to GDP	Total trading volume, divided by the GDP (expressed in 2001 US\$) of a certain country in a given year.	World Bank (2005).
Price to book value of equity	Quotient between the market value of equity and the book value of equity.	Standard & Poor's (2005).
External Cap relative to GNP	The ratio of the stock market capitalization held by minorities to GNP for 1999. The stock market capitalization held by minorities is computed as the product of the aggregate stock market capitalization and the average percentage of common shares not owned by the top three shareholders in the ten largest nonfinancial, privately owned domestic firms in a given country. A firm is considered privately owned if the State is not a known shareholder in it.	Moody's International, CIFAR, EXTEL, WorldScope, 20-Fs, Price Waterhouse, and various country sources.
Domestic firms relative to population	Ratio of the number of domestic firms listed in a given country to the country's population (in millions) in 1999.	Emerging Market Factbook; World Bank (1999).
IPOs relative to population	Ratio of the number of IPOs of equity in a given country to the country's population (in millions) in 1999.	López-de-Silanes (2003).
GDP growth	Average annual percent growth of per capita GDP for the period 1960–1998.	World Bank (2001).
Log GNP	Logarithm of the GNP in 1999.	World Bank (2001).

Source: Compiled by the authors

## Annex 2

### Variables Used in the Comparative Analysis

	Argentina	Brazil	Chile	Colombia	Costa Rica	Mexico	Venezuela, R. B. de
Tobin's q	Is the market value of equity plus the book value of liabilities to book value of assets.	Ratio of market value to book value of assets. Market value of assets is computed as market value of equity plus book value of assets minus book value of equity at year-end values. The numerator "market value of equity" was computed directly by Economática as the most liquidity stock type (voting or non-voting) market price times the total number of shares (voting and non-voting).	Market book of assets / book value of assets at the end of each calendar year. We estimate market value of assets as the book value of debt + book value of preferred stock + market value of common stock.	Ratio between market value of assets to the book value of assets	Yes	Defined as the market value of equity (actual shares outstanding times the closing price of the period)) plus total liabilities divided by total assets.	It is computed as the ratio of market value to book value of assets. Market value is the market value of equity plus the book value of assets minus the book value of equity. They are all computed at the end of 2004.
Return on assets	Earnings before interest and taxes to total assets	Ratio of operating income to total assets (return on assets) at year-end	Return on assets. Net income divided by book value of total assets.	Return on assets		Ratio between net income and total assets. Expressed in percentage points	It is calculated as the ratio of earnings before interest and taxes to end of year total assets for each firm i and for each year t.
Return on equity	Earnings before interest and taxes to total equity			Return on equity		Ratio between net income and the book value of equity (total assets minus total liabilities). Expressed in percentage points	It is calculated for each firm i and for each year t as the ratio of earnings before interest and taxes to end of year total equity.
Dividend payout	Dividends to cash flow: Cash dividends to (total earnings plus depreciation)	Cash and stock dividends/Net Income ratio with year-end values.			Dividends to earnings ratio	Ratio between the dividends paid and net income. Expressed in percentage points.	Cash and stock dividends divided by net income. Data correspond to 2003. They are all computed at year-end values and were obtained from the Anuario de la Bolsa de Valores de Caracas (2003).
Market to book ratio		Market value of stock divided by book value of stock		Market value of common stock and book value of common stock		Ratio between the market value of equity and the book value of equity.	Market value divided by book value at the end of 2004. Market value and book value were obtained from Economática and Datastream.
Corporate governance index	Transparency and disclosure index: 32 binary items grouped in three sub indices. Scaled between 0 and 100	24 binary items on four dimensions. Scaled value between 0 and 24.	67 questions grouped in four sections and scaled from 0 to 20	31 questions grouped in six different aspects scaled from 0 to 100	57 binary questions scaled from 0 to 100	Mean of the corporate governance index for the years 2003 and 2004. This variable is between zero and one and it represents the accomplishment of the corporate governance principles stated in the questionnaire that all listed companies has to present to the Mexican Stock Exchange every year.	

Source: Chong and López-de-Silanes, forthcoming.