The Core Institutions that Support Strong Securities Markets

Author(s): Bernard Black

Source: *The Business Lawyer*, August 2000, Vol. 55, No. 4 (August 2000), pp. 1565-1607

Published by: American Bar Association

Stable URL: https://www.jstor.org/stable/40687950

JSTOR is a not-for-profit service that helps scholars, researchers, and students discover, use, and build upon a wide range of content in a trusted digital archive. We use information technology and tools to increase productivity and facilitate new forms of scholarship. For more information about JSTOR, please contact support@jstor.org.

Your use of the JSTOR archive indicates your acceptance of the Terms & Conditions of Use, available at https://about.jstor.org/terms

JSTOR

American Bar Association is collaborating with JSTOR to digitize, preserve and extend access to *The Business Lawyer*

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

The Core Institutions that Support Strong Securities Markets

*By Bernard Black**

INTRODUCTION

A strong public securities market, especially a public stock market, can facilitate economic growth. But creating strong securities markets is hard. That these markets exist at all is almost magical. Investors pay enormous amounts of money for completely intangible rights, whose value depends entirely on the quality of the information that the investors receive and on the honesty of other people, about whom the investors know almost nothing. This magic does not appear in unregulated markets.

This article explores which laws and related institutions are essential for strong securities markets. My goal is threefold: to explain the precursors of strong markets in countries, like the United States and the United Kingdom, that already have these markets; to offer a guide to reforms that could strengthen securities markets in other countries; and to offer some cautionary words about the difficulty of creating the many institutions that support strong securities markets, for countries that don't now have them.

I argue here that there are two essential prerequisites for strong public securities markets. A country's laws and related institutions must give minority shareholders: (i) good information about the value of a company's business; and (ii) confidence that the company's insiders (its managers and controlling shareholders) won't cheat investors out of most or all of the value of their investment. If these two steps can be achieved, a country has the potential to develop a vibrant securities market that can provide

*Professor of Law, Stanford Law School. A longer version of this Article, including more extensive citations to the empirical literature, will be published as *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. ___ (forthcoming 2000), *available in* Social Science Research Network at <http://papers.ssrn.com/paper.taf?abstract_id=182169>. I thank John Coffee, Rob Daines, David Ellerman, Ron Gilson, Jeff Gordon, Steven Huddart, Cally Jordan, Michael Klausner, William Megginson, and participants in an OECD conference on Corporate Governance in Asia, an IMF workshop on Comparative Corporate Governance in Developing and Transition Economies, the UCLA School of Law First Annual Corporate Governance Conference, and workshops at American Law & Economics Association, Korean Securities Law Association, Seoul National University School of Business, Stanford Law School, and University of Missouri-Columbia for helpful comments and suggestions.

This content downloaded from 149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

capital to growing firms, though still no certainty of developing such a market.[1]

In countries with strong securities markets, good disclosure and control of self-dealing are often presumed. Concerns about "corporate governance" commonly involve a third issue—what institutions can coax managers to maximize firm value, instead of (say) firm size or their own prestige. I do not address value maximization here. My personal view is that in most countries, value maximization is a secondary issue, to be worried about after the issues of disclosure and controlling self-dealing are satisfactorily addressed. Moreover, the institutions that ensure good disclosure and control self-dealing do a decent job of addressing value maximization concerns as well.

Individual companies can partially escape weak home country institutions by listing their shares on a stock exchange in a country with strong institutions and following that country's rules. But only partial escape is possible. A company is still hostage to reputational spillover from other firms in the same country and to investor knowledge that reputation, without local enforcement and other local institutions, isn't nearly as good as the same reputation buttressed by those institutions.

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

The analysis developed here can also inform the debate over the merits of competition between securities regulators. If strong securities markets depend on a complex network of market and government institutions, then the debate is misplaced. Competition between securities regulators cannot exist in anything like the pure form posited by the debaters.

1. Prior work on the prerequisites for strong securities markets includes Bernard Black, *Information Asymmetry, the Internet, and Securities Offerings*, 2 J. SMALL & EMERGING BUS. L. 91 (1998); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996) [hereinafter Black & Kraakman]; John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999) [hereinafter Coffee]. On the empirical correlation between investor protection and strong securities markets, see Florencio Lopez de Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Rafael La Porta, Florencio Lopez de Silanes, Andrei Shleifer & Robert W. Vishny, *Law And Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta, Florencio Lopez de Silanes and Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); Rafel La Porta, Florencio Lopez de Silanes, Andrei Shleifer & Robert W. Vishny, *Investor Protection and Corporate Valuation*, 58 J. FIN. ECON. ___ (forthcoming 2000), *available in* Social Science Research Network at <http://papers.ssrn.com/paper.taf?abstract_id=192549>; Rafael La Porta, Florencio Lopez de Silanes, Andrei Shleifer & Robert W. Vishny, *Agency Problems and Dividend Policies Around the World*, 55 J. FIN. 1 (2000); Franco Modigliani & Enrico Perotti, *Security Versus Bank Finance: The Importance of a Proper Enforcement of Legal Rules* (working paper 2000), *available in* Social Science Research Network at <http://papers.ssrn.com/paper.taf?abstract_id=200559>.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

The next part of this Article explains why controlling information asymmetry is critical for developing strong stock markets, and which laws and institutions are most important in doing so. I then explain why controlling self-dealing is also critical, and the somewhat different laws and institutions that are central for this task. I next explore the extent to which companies can escape weak domestic laws and institutions by relying on foreign laws and institutions, and develop some implications of my analysis for the current debate over competition among securities regulators. I conclude by discussing which steps a developing country should take first to strengthen its securities market.

INFORMATION ASYMMETRY

INFORMATION ASYMMETRY AND REPUTATIONAL INTERMEDIARIES

A critical barrier that stands between issuers of common shares and public investors is asymmetric information. The value of a company's shares depends on the company's future prospects. The company's past performance is an important, albeit partial guide to future prospects. The company's insiders know about both past performance and future prospects. They need to deliver this information to investors, so investors can decide what to pay for the company's shares.

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

In economic jargon, securities markets are a vivid example of a market for lemons. Indeed, they are a far more vivid example than George Akerlof's original example of used cars.[2] Used car buyers can observe the car, take a test drive, have a mechanic inspect the car, and find out about others' experiences with the same car model or manufacturer. By comparison, a company's shares, when it first goes public, are like a unique, unobservable car, on which investors can obtain only dry written information, that they can't directly verify. They have only the comfort of knowing that other, similarly informed investors have reached similar conclusions about value.

Investors don't know which companies are truthful and which aren't, so they discount the prices they will offer for the shares of all companies. This may ensure that investors receive a fair price, on average. But consider

2. George Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

the plight of an "honest" company—a company whose insiders report truthfully to investors *and* won't divert the company's income stream to themselves, apart from a market rate of compensation for management services.

Discounted share prices mean that an honest issuer can't receive fair value for its shares, and has an incentive to use other forms of financing. But discounted prices won't discourage dishonest issuers. Shares that aren't worth the paper they're printed on are, after all, quite cheap to produce. The tendency for high-quality issuers to leave the market because they can't obtain a fair price for their shares, while low-quality issuers remain, worsens the lemons or "adverse selection" problem that investors face. Investors rationally react to the lower average quality of issuers by discounting still more the prices they will pay. This drives even more high-quality issuers out of the market and exacerbates adverse selection.

Some countries, including the United States, have partially solved this information asymmetry problem through a complex set of laws and private and public institutions that give investors reasonable assurance that the issuer is being (mostly) truthful. Among the most important institutions are reputational intermediaries, who vouch for the quality of particular securities. These intermediaries—accounting firms, investment banking firms, law firms, and stock exchanges—can credibly vouch for information quality because they are repeat players who will suffer a reputational loss if they permit a company to exaggerate its prospects, that exceeds the intermediary's one-time gains from permitting the exaggeration.[3] The intermediaries' backbones are stiffened by the risk of legal liability if they endorse faulty disclosure, and government civil or criminal prosecution if they do so intentionally.

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

Most American investors still expect financial statements to be audited, shares to be underwritten by a reputable investment banker, and the prospectus to be prepared by securities counsel. It helps if the issuer is listed on a reputable stock exchange. But investors' reliance on reputational intermediaries merely recreates the fraud problem one step removed. The

3. On the role of reputational intermediaries in securities markets, see Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 595-607 (1984).

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

United States' success in creating an environment in which most reputational intermediaries guard their reputations creates an opportunity for new entrants to pretend to be reputational intermediaries. Merely calling oneself an investment banker will engender some degree of investor trust, because most investment bankers are honest and care about their reputations, and because investors (rationally) don't fully investigate investment bankers' claims that they have strong reputations. The other key intermediaries—accountants and securities lawyers—can similarly trade on their profession's generally honest reputation (notwithstanding the occasional snide joke about whether that reputation is deserved).

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

The combination of ability to free ride on other investment bankers' reputations and low entry barriers creates an opportunity for some entrepreneurs—whom I will call "bogus investment bankers"—to go into the investment banking business, intending never to develop their own reputations, but instead to profit by pretending to investors that their recommendation of a company's shares has value. In effect, bogus investment bankers steal some of the value of their competitors' reputations, while at the same time devaluing those reputations, because bad reputations spill over to the rest of the profession just as good ones do. So too for accountants and securities lawyers.

The result is ironic: Reputational intermediaries' principal role is to vouch for disclosure quality and thereby reduce information asymmetry in the market for securities. But information asymmetry in the market for reputational intermediaries limits their ability to play this role.[4]

4. From this perspective, stock exchanges play a surprisingly limited information-verification role. Entry barriers are significant. A con artist can't easily hire a bogus stock exchange, in the way that the con artist can find a bogus investment bank and compliant (perhaps crooked) accountants and lawyers. Thus, exchanges shouldn't face large externalities in vouching for company reputation. Yet in countries with strong securities markets, exchanges conventionally don't look much beneath the surface of audited financial statements in deciding whether to list a new company, and don't scrutinize who the company's accountants, bankers, or lawyers are. Perhaps the constraints on misdisclosure imposed by other reputational intermediaries are sufficient so that investors don't put much weight on an exchange listing, and the exchanges respond to lack of investor demand by not closely scrutinizing new issuers. This suggests a business opportunity for the major world exchanges: close oversight of new listings could attract companies from countries where other reputational intermediaries are weak.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

There are several nonexclusive solutions to this problem. One is second-tier reputational intermediaries, who vouch for the quality of the first-tier intermediaries. Voluntary self-regulatory organizations (SROs) play this role, in part. A somewhat stronger solution involves *mandatory* self-regulatory organizations. In the U.S., for example, investment bankers must belong to one of two SROs (the New York Stock Exchange or the National Association of Securities Dealers). A member evicted by one is unlikely to be accepted by the other. Thus, a mandatory system lets an SRO put a misbehaving member out of business, not merely deprive it of the reputational enhancement from voluntary membership.

But SROs need to be policed too, lest they recreate the information asymmetry at yet a third level. Low-quality intermediaries can form a lax SRO to vouch for their quality. Investors will then have to figure out whether the SRO is itself a bogus intermediary.[5]

A third solution combines legal rules that make reputational intermediaries liable to investors with minimum quality standards for intermediaries—regulators license the intermediaries; revoke the licenses of misbehaving intermediaries; and initiate criminal prosecution if an intermediary misbehaves intentionally. The greater sanctions available through the legal system, plus the ability to collectivize the cost of enforcement, may explain why these strategies mostly dominate over second-tier reputational intermediaries.

The resulting system, in which multiple reputational intermediaries vouch for different aspects of a company's disclosure, while the government, private plaintiffs, and self-regulatory organizations police the reputational intermediaries, can work tolerably well. But it is scarcely simple. And it may require ongoing government effort to protect reputational intermediaries against bogus intermediaries who would otherwise profit from the spillover of reputation to them.

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

In these countries, a few large companies may develop reputations sufficient to justify a public offering of shares at a price that, though below fair value, is still attractive compared to other financing options. But smaller companies have essentially no direct access to public investors' capital. They must obtain capital from intermediaries (usually banks), or

5. *See* Simon Johnson & Andrei Shleifer, *Coase v. the Coasians* (working paper 1999), *available in* Social Science Research Network at <http://papers.ssrn.com/paper.taf?abstract_id=193776> (Czech investment funds formed SROs, "but some of their powerful members were themselves engaged in tunnelling and opposed strong self-regulation").

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

through the internal capital market of a conglomerate group, or else grow only at the rate permitted by reinvestment of past earnings.

THE CORE INSTITUTIONS THAT CONTROL INFORMATION ASYMMETRY

Countries with strong securities markets have developed a number of institutions to counter information asymmetry, some mentioned above. Information disclosure centers on financial disclosure. I list below the "core" institutions that I consider most important. This list reflects my personal judgment, based on experience in corporate law and capital markets reform in a variety of countries.[6] I present the list in an order that makes logical sense, *not* in order of estimated importance.

I do not address in this article which comes first, legal structure or supporting market institutions. My tentative view is that a central characteristic of the institutions discussed below is that they interrelate—they develop together and to reinforce each other.

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

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

Whether audited financial statements, meeting a common set of accounting standards, must be required by law, or a practice of providing audited financials will emerge anyway, perhaps through a stock exchange rule, is an oft-debated question that I need not address here. A stock exchange rule, itself reflecting common practice, can come first, as in the

6. My home country is the United States. I have also engaged in significant company and securities law legal reform work in Armenia, Indonesia, Mongolia, Russia, South Korea, Ukraine, and Vietnam, and comparative research in Britain and the Czech Republic. *See* Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation,* 92 MICH. L. REV. 1997 (1994); Bernard Black, Reinier Kraakman & Anna Tarassova, *What Went Wrong with Russian Privatization and Corporate Governance,* 52 STAN. L. REV. ___ (forthcoming 2000), *available in* Social Science Research Network at <http://papers.ssrn.com/paper.taf?abstract_id=181348> [hereinafter Black, Kraakman & Tarassova]; Bernard S. Black, Barry Metzger & Timothy O'Brien, *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness* (Report to the Ministry of Justice of Korea), 26 J. CORP. L. __ (forthcoming 2000), *available in* Social Science Research Network at <http://papers.srn.com/paper.taf?abstract_id=222491> [hereinafter Black, Metzger & O'Brien]. Below, occasional footnotes use examples from some of these countries to illustrate points made in the text.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

United States.[7] But a mandatory rule might speed up this process. The arguments for mandatory audits and compliance with a defined set of accounting rules become stronger, the weaker a country's securities markets and the culture of disclosure that supports those markets.[8]

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

Good accounting rules should be designed to provide information in a form that is useful to investors (in many countries, they are designed partly or primarily to assist in assessing taxes). The rules should facilitate evaluating a company's past performance and comparing it with similar companies, both in the same country and internationally. They should limit managers' flexibility to choose among alternative accounting practices to make their firm appear more profitable. Overly flexible rules can reduce comparability, increase information asymmetry between companies and investors, and increase opportunities for fraud.[9] At the same time, the accounting rules must strike a sensible balance among investors' desire for information, the cost of providing the information, and companies' concern that giving detailed information to investors means giving the information to competitors as well.

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

In many countries, accounting rules are written by the Finance Ministry, which often writes rules that provide the information needed to collect taxes, rather than the information that investors need. Thus, the rule-writing task is ideally placed elsewhere—in a securities commission or, as in the United States and Great Britain, in a quasi-public self-regulatory organization run by accountants and supervised by the securities commission or another government agency.[10]

Writing good accounting rules requires close knowledge of how companies operate, how they use loopholes in the rules to portray a firm's

7. *See* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

8. For pieces of the mandatory disclosure debate, see, *e.g.*, Anat R. Admati & Paul C. Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities* (working paper 1998), *available in* Social Science Research Network at <http://papers.ssrn.com/paper.taf?abstract_id=103968>; Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW ch. 11 (1991); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

9. *See* Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335 (1996).

10. For an overview of U.S. and British practice in setting accounting rules, including the advantages and disadvantages of self-regulation, see BRIAN R. CHEFFINS, COMPANY LAW; THEORY, STRUCTURE, AND OPERATION 372-420 (1997).

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

performance as better than it really is, appreciation for changes in corporate practices, and the ability and incentive to write new rules and interpret old ones with reasonable dispatch. Other things equal, this offers some reason to vest rule writing in a quasi-public organization run by accountants, rather than a government agency. If the rule-writing agency is private, its funding and the rules for choosing its members must ensure that the agency is not overly dependent on issuers, whose managers will often prefer opaque disclosure, especially about their own compensation.

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

Audit requirements and accounting rules are no better than the accountants who conduct the audits and apply and interpret the rules. Accounting is part science (following established rules), but in important part remains a skilled art. With the twist that the artist's task is to paint an accurate picture, while the subject pays the artist's fee, often tries to persuade the artist that a more flattering portrait is a truer one, and can replace an artist who paints too unflattering a portrait. In addition, a minority of subjects are crooks, who will do whatever they can to mislead the artist and thus the investors who are the ultimate viewers of the portrait.

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

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

Accountants are reputational intermediaries. When they prepare and review financial statements, they also rent out their reputation for conducting a careful audit that can catch some fraud and discourage attempts at fraud, and for painting a tolerably accurate picture of a company's performance.

Some legal liability is an important buttress for the accounting firm's concern for reputation. Individuals in a large firm have incentives to bend the firm's standards to keep or attract business. Personal liability can partly offset those incentives. The firm's exposure can persuade the firm to establish strong internal procedures to ensure that the financial statements that it prepares or reviews meet minimum quality standards. Liability risk also provides a compelling argument that the accounting firm can offer to

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

a client that wants more favorable treatment than the accounting firm proposes.

The liability risk doesn't have to be great. Frequent, American-style class action litigation against accounting firms isn't needed. Perhaps a handful of lawsuits per decade, a couple of which result in a significant payout, are enough. But without any liability risk, accounting firm partners will sometimes accept the ever-present temptation to squander the firm's reputation to gain a client.[11]

(6) Procedural rules that provide reasonably broad civil discovery and permit class actions or another means to combine the small claims of many investors.

Meaningful liability risk for reputational intermediaries and insiders requires procedural rules that provide reasonable broad civil discovery. Proving misdisclosure often requires information that is buried in the company's records. Without that information, liability rules that seem reasonable on paper may do investors little good in practice.

Also, individual investors often won't incur the expense of a complex lawsuit to recover the investor's small private loss. It is important to have class actions or another way to combine many individually small claims. Contingent fee arrangements are a useful supplement to the class action procedure, but in my judgment not essential.[12]

(7) A sophisticated investment banking profession that investigates the issuers of securities that the investment bank underwrites, because the investment banker's reputation depends on not selling fraudulent or overpriced securities.

Investment bankers are a second key reputational intermediary. In developed securities markets, they have learned to walk the fine line between selling an offering and overselling it. Their role includes investigating the issuer and satisfying themselves that the issuer's future prospects are reasonably stated in the offering documents and sales presentations, that the issuer's managers are honest, and that investors understand the major risks

11. A recent Russian example involves an audit by a big-5 accounting firm of a major Russian oil company. The company was (notoriously) selling oil to its majority shareholder at below-market prices, thus transferring profits from the company to the controlling shareholder. These transactions violated Russian company law, which requires the company's minority shareholders to approve self-dealing transactions. A footnote to the company's 1997 financial statements disclosed mildly that these transactions "may" give rise to liability by the controlling shareholder to the company, with no mention of the amount (which was likely in the hundreds of millions of dollars). A major accounting firm would never bless this paltry disclosure if it faced meaningful liability to investors.

12. For example, South Korea has respectable rules on information disclosure and self-dealing, and allows contingent fees. But its lack of a class action or similar procedure greatly weakens the incentive for good disclosure. *See* Black, Metzger & O'Brien (2000), *supra* note 6.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

of the investment. For example, investment banks routinely conduct background checks on an issuer's insiders and walk away if the insiders have an unsavory past or questionable friends.

Investment bankers' reputation is policed in a number of ways. First, securities purchasers will remember if an investment bank sold them a number of bad investments, and avoid (or pay less for) its future offerings. Second, investment banks keep track of the "aftermarket" performance of their own and their competitors' offerings; happily disclose competitors' weak performance to potential clients; and worry greatly about weak aftermarket performance of their own offerings, because this is a recipe for trouble in the medium to long term.

Third, in the rare cases when a major underwriter unwittingly sells shares for a fraudulent company, which collapse in price when the fraud is discovered, this is a major embarrassment, not soon forgotten by investors or by the bank's competitors, who will bring it up at every convenient opportunity. So too for a debt offering that quickly goes into default because of business problems that the underwriter missed.

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

Legal liability is an important reinforcement for investment bankers' concern for reputation. Liability can help to persuade individual bankers to pursue clients less aggressively, and persuade a firm to establish strong internal procedures to ensure that the companies whose shares it underwrites meet minimum quality standards. Liability risk also provides a strong argument that the investment banker can offer to a client that wants more favorable disclosure than the banker proposes.

As for accountants, I make no claim that frequent litigation against investment bankers is needed. A few lawsuits per decade, a couple of which lead to a significant payout, could be enough. But if there is no liability risk, individuals within a firm will sometimes accept the ever-present temptation to squander the firm's reputation to gain a client and a fat fee.

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

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

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

In my judgment, a significant risk of liability for securities lawyers (in contrast to accountants and investment bankers) is not a core prerequisite for a strong securities market. Lawyers will have enough concern about liability through their training, and have a reputation-based incentive to protect their clients. But some liability risk for lawyers is surely a *useful* institution.

The lawyers' role in securities offerings will often depend on whether companies, insiders, and investment bankers face liability risk. If this risk is real, then companies and investment bankers will protect themselves by hiring lawyers to write and review the key disclosure documents. The lawyer's caution will help to ensure good disclosure, even if lawyers face little direct risk. Conversely, if companies and investment bankers face little liability risk, they may forego hiring expensive securities lawyers to write disclosure documents, and disclosure quality will suffer.[13]

(10) A stock exchange with meaningful listing standards, and the willingness to fine or delist companies that violate disclosure rules.

Stock exchanges are a fourth important reputational intermediary. They establish and enforce listing standards, including disclosure requirements. Investors use the listing as a proxy for company quality. Both investors and the exchange understand that false disclosure by a few companies will taint all listed companies and reduce the value of an exchange listing.

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

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

Often, insiders want to preserve a company's ability to issue shares in the future, and will therefore want to maintain the company's reputation for honest disclosure. But insiders' concern for future reputation isn't enough to ensure honest behavior. Some of the time, the company will be in a financial bind, where if it doesn't raise funds this time, there won't be a next time. In game theory terms, the insiders are in the final period of a repeated game. They have an incentive to cheat, because there won't be a next round in which cheating can be punished.[14] At other times, the

13. An anecdote. I was an expert witness in a recent class action securities case involving a claim of misdisclosure during a merger of two high-technology companies. The proxy statement/prospectus, unlike every other high-tech prospectus I've seen in recent years, contained no "risk factors" section—the natural place where the missing disclosure could have gone. The core sections of the prospectus were written not by securities counsel, but, oddly, by the target company's corporate controller. In my judgment, it's no coincidence that weak disclosure was correlated with lawyer noninvolvement.

14. *See generally* ROBERT AXELROD, THE EVOLUTION OF COOPERATION (1984).

This content downloaded from 149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

insiders' tenure in the company may be at risk. The insiders face a final period, even if the company doesn't. Moreover, some con artists, attracted by the ease of creating valueless companies and selling valueless shares, will happily take whatever money they can raise this time, and then hope to sell another company's shares the next time.

Just as liability to investors helps to ensure that reputational intermediaries behave as they are supposed to, this liability helps to ensure that insiders disclose honestly in the first place. But for insiders, financial liability is not a sufficient deterrent. The insiders often have little wealth outside their firm, or can hide much of their wealth out of investors' reach. That makes criminal sanctions important as well.

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

Honest, decently funded regulators and prosecutors are essential. They are sometimes taken for granted in developed countries, but are often partly or wholly absent in developing countries. Funding is a hidden problem in many countries—the securities regulator may have a minimal budget, or be unable to pay salaries sufficient to retain qualified people or keep them honest.

Specialization is needed too. Even in developed countries, few prosecutors have the skill or interest to bring complex securities fraud cases. Some securities cases involve outright fraud—a company has reported sales or inventory that didn't exist. An unspecialized prosecutor can potentially bring these cases. But these cases aren't sexy. They could get ignored by a prosecutor who would rather convict muggers and murderers. Moreover, many securities fraud cases require careful digging through the company's records to prove that the insiders have twisted the truth, and skill to present the fraud in convincing fashion to a court.

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

An honest judiciary is a must for investor remedies to be meaningful. As with honest prosecutors, this element of a disclosure system can be taken for granted in developed countries, yet is often partly or wholly absent in developing countries. Decent judicial salaries are a necessity, if one is to hope that judges will stay honest. So are honest prosecutors—lest a powerful defendant combine a promised bribe if a judge is compliant with a personal threat if she is not.

With regard to sophistication, the same subtle securities fraud cases that call for specialized prosecutors require sophisticated judges. The ideal

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

would be a specialized court, staffed by judges with prior experience as securities or transactional lawyers. A general court that sees a hefty percentage of securities and other complex commercial cases, perhaps because it is located in the country's financial center, is an acceptable substitute.

Speed is important too. When insiders commit fraud, some of the money can sometimes be retrieved if prosecutors can quickly freeze the insiders' assets pending the final outcome. Otherwise, the assets are as good as gone—any good con artist can move his assets beyond the prosecutor's reach if given a warning that they may be seized or lost in a civil action. More generally, differences between countries in how fast courts move are often large, and affect the salience of investor remedies. Many countries award no or inadequate interest on judgments, which undercuts the official sanctions.

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

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

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

Transparent market prices raise their own dangers. Especially in "thin" markets, insiders can manipulate trading prices to create the appearance that a company's shares are highly valued by outside investors, while dumping their own shares on the market. The principal response to this risk is rules against manipulating trading prices. These rules must be enforced by a specialized regulator, because manipulation is notoriously hard to prove.

(16) An active financial press and securities analysis profession that can uncover and publicize instances of misleading disclosure, and criticize the company, its insiders, and (when appropriate) the investment bankers, accountants, and lawyers.

Markets for reputation require a mechanism for distributing information about the performance of companies, insiders, and intermediaries.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

Disclosure rules for companies help, as does reputational intermediaries' incentive to advertise their successes. But intermediaries won't publicize their own failures. Their competitors may do so, but investors will discount a competitor's report because it comes from a biased source. Besides, attack ads invite retaliation in kind. An active financial press is an important source of reporting of disclosure failures.

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

Securities analysts are another important source of coverage of particular companies. They conduct a delicate balancing act between maintaining a reputation for objectivity and bowing to pressure from companies, who can retaliate for negative coverage by cutting off the analyst's access to soft information. For analysts who are employed by investment banks, there is also pressure from their employers not to say nasty things about a client or potential client (in other words, about any company at all!). Nonetheless, they can play an important role in uncovering aggressive financial reporting by particular companies. An active financial press can help analysts maintain a tolerable balance between disclosing bad news and pleasing covered companies and their own employer, by reporting on analysts' reputations among investors.[15]

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

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

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

The length of this list suggests the difficult task facing a country that wants to develop a strong stock market. Formal disclosure rules are only

15. An American example is the analyst rankings published annually by *Institutional Investor* magazine, *available in* <http://www.iimagazine.com/research/99/aart/best.html>. A high ranking significantly increases an analyst's expected income and job mobility.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

a start. The harder task is enforcing the rules. This includes both direct public enforcement and indirect enforcement through reputational intermediaries, securities analysts, the financial press, and other market institutions.

ADDITIONAL USEFUL AND SPECIALIZED INSTITUTIONS

The above list of core institutions reflects my personal judgment about which rules and institutions are *most important* for ensuring good information disclosure. It omits some indirectly related institutions that are also essential for a good disclosure system. For example, a confiscatory tax system (Russia's, say) precludes honest disclosure of profits, and thus precludes good disclosure.

This judgmental list of *core* institutions is not a complete list of the *useful* rules and institutions. For example, I argue above that it is important for accountants and investment bankers to face a meaningful risk of liability to investors. It is also useful for these intermediaries to be subject to a regulatory licensing scheme, under which misbehaving individuals and firms face sanctions, including fines, suspension and license revocation. These regulatory sanctions aren't listed above because I believe that, especially in less developed economies, liability to investors is a more effective tool for enforcing good behavior by reputational intermediaries than regulatory sanctions. Even in countries with strong regulators, regulatory sanctions are imposed infrequently. They will be an even weaker constraint in emerging economies, which have fewer regulatory resources and perhaps better uses for those resources (such as pursuing the insiders who commit fraud, rather than the intermediaries who merely fail to catch the fraud).

A useful supplement to government regulation of reputational intermediaries is self-regulation, though a self-regulatory organization (SRO), either voluntary or mandatory, that is itself subject to regulatory oversight. But if other constraints are weak, self-regulation isn't likely to be strong either. Just as potential liability to investors makes reputational intermediaries more willing to insist that their clients provide good disclosure, it makes the intermediaries more willing to create a strong SRO, provide it with a decent budget, and support the SRO's efforts to discipline or expel errant members.

For securities lawyers, liability to investors is less important than for accountants and investment bankers, and hence not listed above as a core institution. But some risk of liability to investors is a useful supplement to lawyers' trained caution and concern to protect their clients against liability.

Investment funds (Americans call them "mutual funds," for some odd reason) are another useful institution. They can collect money from individual investors, while providing those investors with diversification and

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

some insulation against inflated claims by con artists (who will have a harder time fooling experts than novices). A strong investment fund industry can provide a source of funds to be invested in the securities market, and a source of market and political demand for strong disclosure. The investment fund industry relies on still other related institutions, including an investment fund law that protects a fund's assets against self-dealing by the fund's manager, a regulatory structure that disciplines bad actors and limits fund managers' ability to puff their past performance, and a financial press that rates fund performance. I didn't list investment funds as a core institution because, in my judgment, a healthy investment fund industry is more a result than a cause of a strong securities market.

Funded private pension plans are a further useful institution. Like investment funds, they are both a source of investable funds for which public securities markets are a natural outlet, and a source of market and political demand for good disclosure.

For particular types of companies or for securities other than common stock, additional institutions can be important, even crucial. For example, investors in high-technology companies face severe information asymmetry problems, because these companies often have short histories, make highly specialized products, participate in fast-moving industries that are hard for investors to understand, and have growth prospects (and thus value) that can't be easily extrapolated from past financial results. This makes it easier for insiders to exaggerate their company's prospects. As a result, even countries with strong stock markets have developed a specialized institution—the venture capital fund—that funds high-technology companies early in their life and functions in significant part as a specialized reputational intermediary. Venture capital funds closely investigate companies that seek funding, and then implicitly vouch for these companies when the companies later raise capital in the securities markets.[16]

Ronald Gilson and I argue in a recent article that to understand how venture capital funds operate, you have to understand the synergy between their visible role in providing financial capital and their less visible but equally important role in providing reputational capital and monitoring. For early stage, high-technology companies, the combination of these three services dominates the alternative that public securities markets offer of providing financial capital *without close monitoring*, as well as the alternative of an institution that monitors and provides reputational capital *without investing*, which is a plausible arrangement that we don't see.[17]

16. On the role of venture capital funds as reputational intermediaries, see Alon Brav & Paul Gompers, *Myth or Reality? The Long-Run Underperformance of Initial Public Offerings: Evidence from Venture and Nonventure Capital-Backed Companies*, 52 J. FIN. 1791 (1997); Paul Gompers & Josh Lerner, *Conflict of Interest in the Issuance of Public Securities: Evidence from Venture Capital*, 42 J.L. & ECON. 1 (1999).

17. Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON. 243 (1998); *see also* Thomas Hellmann & Manju

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

If developing a strong public stock market is hard, developing a strong venture capital industry is harder still. Venture capital funds face a classic chicken and egg problem in getting started—a venture capitalist can't get funding until he develops a reputation for making good investments, but can't develop a reputation without making investments. Thus, the initial stages of industry development are likely to be slow. We should expect—and as we look around the world we find—that strong venture capital is even rarer than a strong public stock market.

For bonds and other fixed-income investments, rating agencies such as Moody's and Standard & Poor's are another specialized reputational intermediary. In the United States, rating agencies more often follow the bond market than lead it.[18] But rating agencies are important in less-developed bond markets, where they provide not only company-specific ratings, but also country-risk ratings that are not easily or credibly obtained in another way.

For money managers who manage pension funds and other institutional assets, a cottage industry has arisen of consulting firms who verify the money managers' performance claims, and a related industry that develops performance indexes against which the performance of a money manager with a particular style or investment focus can be measured.

Even this further list of useful institutions omits some of the institutions that support an advanced securities market—compliance officers within investment banks, who help to ensure that investment bankers' desire for fees doesn't override concern for legal niceties or long-term reputation; an audit committee of the board of directors, to whom the auditors report, that gives the auditors some protection against management pressure for lenient treatment; inside accountants and lawyers who are acculturated to honest disclosure, which makes fraud harder to undertake in the first instance; and so on.

WHICH INSTITUTIONS ARE NECESSARY; WHICH MERELY NICE TO HAVE?

My long list of core institutions for ensuring good disclosure, my still longer list of useful institutions, and the additional core institutions for controlling self-dealing (discussed below), raise an obvious question: Which institutions are really necessary, and which are just frosting on an already tasty cake? Underlying that question is American history, in which strong securities markets developed together with some of these institutions but

Puri, *The Interaction Between Product Market and Financing Strategy: The Role of Venture Capital*, REV. FIN'L STUD. (forthcoming 2000), *available in* Social Science Research Network at <http://papers.ssrn.com/paper.taf?abstract_id=173655>.

18. For a skeptical review of the role played by rating agencies in American capital markets, see Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U.L.Q. 619 (1999).

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

predated others. The United States had active securities markets long before it had a strong central securities regulator (though it early developed state regulation of securities offerings). And the United States had a strong central securities regulator long before that regulator enforced insider trading rules (a institution that I consider important for controlling self-dealing).

There is no simple answer to this question. Instead, one must evaluate how important each institution is, both on its own and as part of an overall system. Consider insider trading. Bhattacharya and Daouk report that an enforced ban on insider trading raises share prices by about 5%, other things equal.[19] That suggests that this ban plus accompanying enforcement, is important enough for me to call it a core institution, but not absolutely critical. A stock market can be strong without controls on insider trading; it will be stronger with these controls.

On the other hand, honest courts and regulators are critical. A strong stock market can't exist if major players can escape liability by bribing a judge to forgive their trespasses or bribing a regulator to ignore them. I can't prove this, but neither can I think of any counterexamples.

Another dimension, for countries that want to build stronger stock markets, is how long that process will take. A business culture supporting good disclosure and the impropriety of self-dealing can predate law, and over time generate demand for laws that reinforce the culture. But good laws and well-funded regulators can also accelerate the development of other market institutions and help to shape the business culture.

PROTECTING MINORITY INVESTORS AGAINST SELF-DEALING

SELF-DEALING AS AN ADVERSE SELECTION/MORAL HAZARD PROBLEM

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

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

> *direct* self-dealing, where a company engages in transactions, not on arms-length terms, that enrich the company's insiders, their relatives, friends, or a second company that the insiders control; and

19. Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading* (working paper 1999), *available in* Social Science Research Network at <http://papers.ssrn.com/paper.taf?abstract_id=200914> [hereinafter Bhattacharya & Daouk].

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

indirect self-dealing (often called *insider trading*), where insiders use private information about the company to trade with less-informed investors.

Direct self-dealing is far and away the more important problem. First, it's far more profitable for insiders. Direct self-dealing can turn 50% ownership of shares into 100% ownership of profits, with little or no additional investment. Insider trading can't achieve anywhere near that level of profits. For one thing, insider trading in significant volume requires a liquid stock market, which countries that don't control direct self-dealing won't have. For another, a long-term buy-and-hold investor isn't directly harmed by insider trading. You can only be on the losing side of a trade with an insider if you're trading.

More critically, if direct self-dealing is hard to control, insider trading in anonymous securities markets is even harder to control. A telling statistic: The New York Stock Exchange spends about $100 million annually on market surveillance, mostly to control insider trading.

Moreover, unless a country has the institutions that are needed to control direct self-dealing, it has little hope of controlling insider trading. But the converse isn't true. A country can control direct self-dealing reasonably well, without making the additional investment needed to address insider trading.

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

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

This adverse selection by issuers, in which high-quality issuers leave the market because they can't obtain a fair price for their shares, while low-quality issuers remain, lowers the average quality of issuers. Investors rationally react by discounting still more the prices they will pay. This drives even more high-quality issuers away from the market and exacerbates the adverse selection problem. As with asymmetric information, failure to control self-dealing can result in a "death spiral," in which self-dealing and adverse selection combine to drive almost all honest issuers out of the market and drive share prices to zero, save perhaps for a few large companies that can develop reputations sufficient to justify a public offering of shares.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

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

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

Third, once a company has issued shares at a discounted price, in a market characterized by information asymmetry, self-dealing, and resulting adverse selection and moral hazard, the insiders may feel *entitled* to appropriate most of the company's value for themselves. They will resist any change in legal rules that limits this opportunity. An example can illustrate why insiders can feel this way.[20]

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

If the insiders behave honestly and keep only 50% of the company's value, they have cheated themselves. Their shares will be worth only $62.50, while the outside investors' shares will be worth $62.50—far more than the outside investors paid. The insiders' rational response is to self-deal enough to capture at least 80% of the firm's value—$100 out of the total value of $125. They will not feel that they have cheated anyone by doing so. They will fight against legal and institutional reforms that might prevent them from taking what they see as their fair share of the company's value.

Yet, in opposing reforms, insiders of already public companies reinforce a system that won't prevent them from taking more than 80% of the

20. This example is adapted from Coffee (1999), *supra* note 1.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

company's value, if they choose—and some insiders will so choose. If a national system permits substantial self-dealing, there is no obvious way to ensure that investors get, from any particular company, the fraction of company value that they paid for.

THE CORE INSTITUTIONS THAT CONTROL SELF-DEALING

Just as successful securities markets have developed institutions to counter information asymmetry, they have developed institutions to counter self-dealing. Some of these are the same institutions that control information asymmetry; some are different institutions. My judgmental list of core institutions is presented below. The list is in an order that makes logical sense, not in order of estimated importance.

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

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

(2) Review of self-dealing transactions by a company's accountants, to ensure that they are accurately disclosed.

Insiders have a powerful incentive to hide self-dealing despite formal disclosure obligations. Just as reputational intermediaries are needed to police companies' disclosure of financial information, they are needed to police disclosure of self-dealing transactions. Accountants are the obvious intermediary that can play this role. Unlike the situation when a company issues shares to investors, there is no discrete transaction that lets investors insist on intervention by reputational intermediaries. Accountant review of self-dealing transactions can emerge through law or custom. But unless it is mandated, it's not likely to emerge quickly.

If accountants play this information disclosure role, we will also need:

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

Insiders who are determined to self-deal can sometimes do so even with an accountant looking over their shoulders. The insiders can disguise a transaction, or their interest in the transaction, by running one or both through intermediaries. For review by accountants to be effective, the accountants must be sophisticated enough to catch the less subtle subterfuges, and thus raise the transaction costs of self-dealing.

Accountants can't catch all self-dealing. It would cost too much for them to investigate every transaction. But that only reinforces the importance

This content downloaded from
149.10.125.:ffff:ffff:ffff on Thu, 01 Jan 1976 12:34:56 UTC
All use subject to https://about.jstor.org/terms

of professional skill, including knowledge of which closets are most likely to contain skeletons, so the accountants can make productive use of limited resources.

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

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

The reasons for liability risk are the same for self-dealing as for general disclosure. Accountants are hired by insiders, who would prefer to self-deal without disclosure. The accountants will inevitably face pressure to overlook suspicious closets, accept a dubious transaction at face value, or disclose few details to investors about an acknowledged self-dealing transaction. Professionalism is one bulwark against stopping an investigation too early or disclosing too little. But liability to investors is an important bulwark for professionalism.

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

Disclosure alone will deter some self-dealing. But much self-dealing will still take place if the underlying transactions are lawful. In a country such as the United States, with a culture of independence for outside directors, and skilled courts that can sanction self-dealing when a shareholder sues ex post, it may be sufficient to vest approval power solely in the independent directors. But often, nominally independent directors won't be fully independent in fact, especially for a company with a controlling shareholder, where the directors serve at the controlling shareholder's pleasure. Thus, it is valuable to place approval power, especially for larger transactions, in the hands of noninterested shareholders.[21]

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

Insiders have an incentive to disguise their share ownership in a company, and other companies that the first company deals with, in order to

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

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

conceal their influence, and thus the self-dealing nature of a transaction. If noninterested shareholders have decisionmaking power over self-dealing transactions, insiders have a further incentive to disguise their ownership, so they can pretend to be noninterested. Disclosure rules, and rules that treat affiliates of insiders as interested shareholders, are needed to prevent this.

More generally, as long as self-dealing is a significant risk, it's important for outside investors to know who the insiders are. This will help the outside investors to decide how much to trust the insiders, and give the insiders an incentive to develop reputations for not abusing their power.

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

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

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

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

As for information disclosure, meaningful liability risk requires not just formal liability rules, but also procedural rules that provide for reasonably broad civil discovery, and class actions or another means to aggregate individually small claims.

The need for broad discovery is even more crucial for self-dealing than for general disclosure. For general disclosure, there is usually a written disclosure document that will sometimes be false on its face. In contrast, for self-dealing, insiders are dealing with themselves or (for insider trading) with an anonymous market. They can often arrange a transaction without a telltale paper trail, or with a deliberately obscure trail.

The judicial system must therefore permit proof of wrongdoing to be based on circumstantial evidence.[22] Rules that shift the burden to insiders

22. In Russia, for example, even if judges were honest, self-dealing could rarely be proven because courts insist on documentary proof of almost all factual assertions.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

to prove fairness, once self-dealing is established, or to disprove self-dealing once suspicious circumstances are established, can be highly valuable.

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

As for information disclosure, specialization and adequate funding are essential, yet absent in many countries. Insiders can use transactional complexity and multiple intermediaries to hide their interest in a transaction, and anonymous offshore accounts to hide insider trading. Proving a self-dealing case often requires tracing a chain of circumstantial evidence that will befuddle an ordinary prosecutor, or at least lead him to seek out easier cases.

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

As for information disclosure, honest, sophisticated, and decently paid judges are basic and often absent, as is the courts' ability to produce timely decisions and freeze assets before they are moved offshore.

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

I suggested above that approval by nominally independent directors is often an insufficient safeguard against self-dealing transactions, in countries where the directors' independence is in doubt. But independent director approval remains an important safeguard. The directors' potential liability if they don't behave independently is a central support for this constraint.

Independent directors must be given the benefit of the doubt when they approve a transaction, or else truly independent directors will hesitate to serve for fear of financial liability. But if self-dealing is egregious, the need for liability, which can instill backbone in the directors, outweighs the potential chill on directors' willingness to serve. After all, the independent directors have a safe (if uncomfortable) response when a self-dealing transaction is proposed—they can discourage the transaction or bend over backwards to ensure fairness.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

(12) Sophisticated securities lawyers who can ensure that companies satisfy the disclosure requirements and procedural protections governing self-dealing transactions.

The disclosure for a self-dealing transaction, developed to obtain shareholder approval for the transaction, or an annual disclosure report that lists self-dealing transactions during the past year, will commonly be prepared by securities counsel. An important safeguard of the accuracy of this disclosure is counsel's willingness to warn their clients about the risks of partial disclosure, conduct due diligence, and satisfy themselves that the disclosure is accurate. Liability risk will help to ensure that insiders employ sophisticated counsel to prepare this disclosure.

(13) An active financial press and securities analysis profession that can uncover and publicize instances of self-dealing.

Insiders will self-deal less often; and independent directors, accountants, and securities lawyers will be more vigorous in policing self-dealing; if a country has a financial press that is ready and eager to publicize misdeeds. As for financial disclosure generally, a country's libel law is important, to ensure that press reporting is not unduly chilled by fear of a libel suit from an insider, who can finance the suit with the company's money.

Reports of self-dealing will often come from securities analysts rather than the financial press. The more prevalent self-dealing is in a particular country, the greater the need for analysts to understand how self-dealing varies from company to company, both in valuing companies and advising clients on which companies' shares to buy.[23]

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

In countries with strong securities markets, the sanctions against self-dealing are collectively strong enough to reinforce a norm against these

23. Two Russian examples: First, the Troika Dialog investment bank publishes a weekly news bulletin "On Corporate Governance Actions" that advises clients in blunt terms about known and suspected corporate governance shenanigans by Russian companies. *See also* JAMES FENKNER & ELENA KRASNITSKAYA, CORPORATE GOVERNANCE IN RUSSIA: CLEANING UP THE MESS (Troika Dialog 1999). Second, the Brunswick Warburg investment bank published in 1999 a ranking of the corporate governance "risk" posed by Russian firms, with risk ratings ranging from 7 for Vimpelcom (which publishes financial statements reconciled to U.S. GAAP and has shares listed on the New York Stock Exchange) to 51 for the subsidiaries of Yukos. *See* BRUNSWICK WARBURG, MEASURING CORPORATE GOVERNANCE RISK IN RUSSIA (Aug. 31, 1999).

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

transactions. The culture further reduces the frequency of the transactions and ensures that the transactions that occur are less likely to be grossly unfair to the company.

To take one of many recent examples of Russian self-dealing, it would simply never occur to the managers of an American oil company, as it did to the managers of the Russian oil company Yukos, to propose that the company sell its oil to supposedly unaffiliated offshore companies, that no one has ever heard of, for the ruble equivalent of $1.30 per barrel, when the market price was $13 per barrel (and on its way higher, while the ruble depreciated against the dollar).[24] The managers wouldn't propose such a transaction, the independent directors wouldn't approve it, and if it somehow occurred anyway, the accountants would qualify their report on the company's financial statements, the press would report the scandal, and the managers would face both civil and possible criminal liability.

Thus far, the list of core institutions has focused on the institutions needed to control direct self-dealing. I list next the institutions that help control insider trading. Some address both direct self-dealing and insider trading.

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

To be effective, a ban on insider trading must include a ban on tipping others, as well as on trading yourself. The rules must be enforced, lest insiders learn that they can violate the rules with impunity.[25]

(16) A good overall financial disclosure regime.

Good overall financial disclosure makes it harder to hide direct self-dealing. Moreover, the better the information that a company provides to the public, the smaller the profit opportunity from insider trading.

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

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

24. Black, Kraakman & Tarassova (2000), *supra* note 6.

25. Bhattacharya & Daouk (1999), *supra* note 19, report that (i) many countries have bans on insider trading that are never enforced; (ii) *enforced* insider trading rules enhance share prices by around 5%; and (iii) unenforced rules don't affect share prices.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

(18) Rules ensuring transparency of trading prices.

Insider trading flourishes in the dark. The better the trading price is as a guide to actual value, the harder it is for insiders to profit by trading with outsiders. This requires not only general financial disclosure, but also transparent trading prices.

(19) Enforced rules banning manipulation of trading prices.

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

This list suggests the difficult task facing a country that wants to control self-dealing. Rules on paper are necessary but not sufficient. Enforcement is critical. For example, the Russian company law contains reasonably strong procedural protections against self-dealing transactions. But in practice, Russian companies routinely ignore these rules because they are rarely enforced. Insiders hide self-dealing transactions, and (sometimes corrupt) prosecutors and judges usually let the insiders off the hook when a transaction is exposed. Reputational intermediaries—including major international investment banks and major accounting firms—have sometimes chosen to squander their reputations rather than lose big Russian companies as clients, in a country where they face little liability risk.

Incremental steps can help, especially for large companies that can also develop their own reputations. For example, Italy and Germany have taken important steps in the last several years toward better disclosure of self-dealing. These countries have also experienced a significant increase in initial public offerings and in the ratio of market capitalization to GNP. I don't think this is a coincidence. Italy and Germany would likely achieve further growth in stock market capitalization if they enhanced not only their disclosure rules but also their procedural protections against self-dealing transactions.

But these changes don't come easily. The German and Italian disclosure rules were controversial, partly because they transfer wealth in already public companies from insiders to outside shareholders. And German opposition—presumably for similar reasons—was long the main barrier to adoption of a proposed European Company Law Directive that incorporates the British system of takeover regulation, which requires a new controlling shareholder to offer to buy out minority shareholders at the price that the controlling shareholder paid to acquire control.[26]

26. For the original proposed Directive, see Commission Proposal for a Thirteenth Di-

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

ADDITIONAL USEFUL AND SPECIALIZED INSTITUTIONS

The list of core institutions above reflects my personal judgment about which rules and institutions are most important for controlling self-dealing. It is not a complete list of the *useful* rules and institutions. A useful but not core institution in a country where self-dealing is an important risk: a "takeout bid" requirement that a new controlling shareholder offer to buy out all other shareholders at a per-share price comparable to the price that the controlling shareholder paid to acquire control. This rule gives outside investors comfort that, while they must still bet on the honesty of a company's current controllers, they have an assured exit at a reasonable price if control changes hands.

Another useful institution is a one-share, one-vote rule or, more generally, rules that restrict pyramid ownership structures. A disparity between voting control and economic rights increases controllers' incentives to self-deal.[27]

Rules that require insiders to disclose their trades, either not long after the trade, as under current United States law, or even before trading, limit the opportunity for insider trading by "true" insiders (managers and controlling shareholders), and reduce the profit from doing so.[28] So do rules, or common practice driven by fear of liability, that restrict trading shortly before an earnings or other major announcement.

Investment funds and funded private pension plans are indirectly useful institutions. These institutions are natural investors in publicly traded securities. They don't directly control self-dealing, but can provide political support for the government institutions, and market demand for the market institutions, that control self-dealing.

For debt securities, an additional core institution is a bankruptcy system that limits asset stripping and lets creditors recover most of a company's assets after it defaults. For equity markets, a bankruptcy system that controls asset stripping is useful because it supports an overall climate that discourages self-dealing outside bankruptcy, but I don't view it as a core

rective on Company Law Concerning Takeover and Other General Bids, 1990 O.J. (C 38) 41, 44. A watered down directive was nearing adoption as of this writing. *See* European Commission press release, Internal Market Council Close to Agreement on Proposed Takeovers Directive (June 21, 1999), *available in* <http://europa.eu.int/comm/dg15/en/company/company/takeover.htm>.

27. For evidence on the valuation effect of a one-share, one-vote rule, see Stijn Claessens, Simeon Djankov, Joseph Fan & Larry Lang, *On Expropriation of Minority Shareholders: Evidence From East Asia* (World Bank working paper 2088, 1999) *available in* Social Science Research Network at <http://papers.ssrn.com/paper.taf?abstract_id=202390>. On pyramid structures, see Lucian Arye Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights*, *in* CONCENTRATED OWNERSHIP ___ (Randall Morck ed., forthcoming 2000) *available in* Social Science Research Network at <http://papers.ssrn.com/paper.taf?abstract_id=147590>.

28. *See* Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303 (1998).

This content downloaded from 149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

institution. Conversely, institutions that control insider trading are less important for debt markets.

Some scholars argue that common law (as opposed to civil law) courts are a useful source of investor protection. Common law courts have greater latitude to develop and apply vague fiduciary principles to the many guises in which self-dealing can occur.[29]

PIGGYBACKING ON OTHER COUNTRIES' INSTITUTIONS

Table I combines the lists of institutions in the two previous parts into a single list of 25 core institutions that ensure good disclosure, control self-dealing, or both. Table I also addresses to what extent a *company* located in a country that lacks many of these institutions can piggyback on other countries' institutions, and to what extent an entire *country* can piggyback on other countries' institutions. Table I includes my rough judgments, on a 1-5 scale, of how easily a company or an entire country can piggyback on foreign institutions. A rough translation of the 1-5 scale is:

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

The rankings are intended to move beyond general discussion of whether piggybacking is feasible, into detailed consideration of which institutions can be piggybacked (and how effectively), which can't, and the obstacles to effective piggybacking. That, in turn, can inform a national reform strategy.

Some general themes emerge from these rankings. First, only a few institutions are easily transplantable. The most basic institutions are the hardest to transplant. One can't transplant honest or competent regulators, prosecutors or judges. Thus, one can't transplant enforcement against locals—insiders and independent directors. One also can't easily transplant culture. Enforcement and culture are related: without enforcement, a

29. *See* John C. Coffee, Jr., *Privatization & Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1 (1999); Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunnelling* (Harvard Inst. of Econ. Research Paper No. 1887, 2000), *available in* Social Science Research Network at <http://papers.ssrn.com/paper.taf?abstract_id=204868>.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

Table I

Estimated Ease of Piggybacking on Foreign Institutions

	Needed for:		Piggybacking Ease	
Core Securities Market Institutions	Information Disclosure	Controlling Self-Dealing	for a *Company*	for a *Country*
1. Securities laws requiring full disclosure of financial results and self-dealing transactions	x	x	4	3
2. Criminal liability for insiders who intentionally violate the disclosure and self-dealing rules	x	x	1	1
3. An honest, sophisticated securities agency (and prosecutors for criminal cases)	x	x	1	1
4. Honest, sophisticated, well-functioning courts	x	x	1	1
5. An active financial press and securities analysis profession	x	x	3	2
6. A culture of compliance with the disclosure and self-dealing rules by insiders, reputational intermediaries, and independent directors	x	x	2	1
7. Good accounting rules	x	x	4	3
8. A good organization to write accounting rules	x	x	4	3
9. Requirements for audited financial statements	x	x	4	3
10. A sophisticated accounting profession	x	x	4	2
11. A sophisticated investment banking profession	x		4	2
12. Sophisticated securities lawyers	x	x	4	2
13. A stock exchange with meaningful listing standards and active insider trading surveillance	x	x	5	3
14. Market transparency	x	x	4	3
15. An enforced ban on market manipulation	x	x	3	2
16. Civil liability risk for accountants	x	x	3	2
17. Civil liability risk for investment bankers	x		3	2
18. Civil liability risk for insiders	x	x	2	1
19. Civil liability risk for independent directors who approve gross self-dealing		x	2	1
20. Good civil discovery rules and a class action or similar procedure	x	x	1	2
21. Accountant review of the disclosure of self-dealing transactions		x	4	2
22. Inclusion of independent directors on company boards		x	3	2
23. Procedural controls on self-dealing transactions (review by independent directors, noninterested shareholders, or both)		x	4	3
24. Ownership disclosure rules		x	4	3
25. Enforced securities or other rules banning insider trading		x	3	2
Mean ranking:			3.08	2.08

This content downloaded from 149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

strong compliance culture isn't likely. A company's promise to obey another country's tougher rules—bonded by listing on the other country's stock exchange and hiring internationally known accountants, investment bankers, and lawyers—has substantial value.[30] Firms can further enhance their own reputations over time, by obeying foreign rules. But their valuations will still lag those of countries with strong local institutions. With neither strong local enforcement nor good local culture, investors will discount a company's promises. Moreover, in many countries, only the largest companies can afford to hire world-class accountants, bankers, and lawyers.

Consider Vimpelcom—a Russian telephone company that went public in the United States, is listed on the New York Stock Exchange, has most of its shareholders in the U.S., and is subject to U.S. accounting requirements and securities laws. That effort helps Vimpelcom's shares to trade at a higher multiple of earnings than a comparable Russian company that follows domestic rules. But investors still heavily discount Vimpelcom's shares, compared to an American company with the same apparent prospects. They know that Vimpelcom's insiders can cheat and get away with it, or they may sell control to someone else who will behave badly.

It might help for Vimpelcom to bind itself in its charter more tightly than Russian law requires. But investors won't fully trust an untested charter provision, especially one that must be enforced in unreliable Russian courts. For example, another Russian company, Noyabrskneftegaz, not long ago, simply violated a charter provision that granted preemptive rights to shareholders, and instead sold shares cheaply to insiders. The resulting lawsuit by minority shareholders found an unfriendly reception in the Russian courts and has been abandoned.[31]

The strategy of listing shares overseas can also be at the mercy of domestic politics. For example, in 1998, the Malaysian government declared that Malaysian shares traded on the Singapore stock exchange were untradeable. Some Malaysian companies then proved their own untrustworthiness by offering to buy the frozen shares back from investors at a steep discount to market.[32]

Second, an individual company can, with some effort, borrow a reasonable number of institutions from abroad. In 18 of the 25 categories, I

30. On the valuation effects for foreign companies that list their shares in the United States, see Darius P. Miller, *The Market Reaction to International Cross-Listings: Evidence from Depositary Receipts*, 51 J. FIN. ECON. 103 (1999); Vihang R. Errunza & Darius P. Miller, *Market Segmentation and the Cost of Capital in International Equity Markets* (working paper 1998), *available in* Social Science Research Network at <http://papers.ssrn.com/paper.taf?abstract_id=99833>.

31. *See* Bernard Black, *Shareholder Robbery, Russian Style*, ISSue Alert, Oct. 1998, at 3 (published by Institutional Shareholder Services).

32. *See Malaysia's Stockmarket: Daylight Clobbery*, ECONOMIST, July 10, 1999, at 71; Raphael Pura, *Turmoil Grows Over Fate of Frozen Malaysian Shares*, WALL ST. J., Dec. 31, 1999, at A6.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

rate piggybacking potential for an individual company at 3 or above. The mean rating is 3.08.

Third, it's much harder for an entire country, and thus for smaller firms, to piggyback on foreign institutions than for a single major firm to do so. For example, a single firm, at some cost, can adopt international accounting standards. For an entire country, the feasibility of adopting international standards is limited by the sophistication of local accountants and the extent to which local laws are tied to the old accounting rules, in which case the laws must be changed as well.

Fourth, local enforcement and local culture emerge over and over again as key obstacles to the ability of a company or an entire country to piggyback on foreign rules.

In the table above, 18 of the 25 institutions receive a country rank of 1 or 2. The 2.08 mean rating for a country is a full point lower than the 3.08 mean for an individual company.[33]

The reasoning underlying these rankings follows. Almost every reader will likely disagree with me on some of the rankings. I've waffled back and forth on some myself. Yet, as a whole, I think the rankings paint a reasonable picture of the possibility and limits of piggybacking.

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

> A company can, without great difficulty, list on the New York Stock Exchange or NASDAQ and subject itself to United States disclosure and accounting rules. The company and its insiders still may not follow the disclosure rules as attentively as an American company, nor as honestly if the company gets into financial trouble and faces a final period problem. Hence the ranking of 4 instead of 5.
>
> It's harder for a whole country to borrow disclosure rules. For example, an attempt to transplant American securities laws wholesale to another country will likely fail. The rules won't mesh with other local institutions, will likely conflict with other local laws, will be far more complex than needed, and will in some respects be *weaker* than needed, because official rules can be less strict when market institutions are strong. Instead, borrowing securities law from abroad takes careful collaboration between domestic draftsmen and foreign experts who can explain how their rules really work. This is a slow process. The end product will be imperfect before it gets to the legislature, and still more imperfect (perhaps much more so) when it emerges from the legislature. Thus, I can't rate the transplantability of a whole body of law higher than 3.

33. A caveat: I call these "country" rankings, and for the most part they are. But some countries are too small to support a national stock exchange, and are likely to rely instead on a regional exchange.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

2. *Criminal liability for insiders who intentionally violate the disclosure and self-dealing rules* (company ranking = 1; country ranking = 1)

> A single company can't do much to import criminal sanctions against insiders. It must rely on its home country institutions.
>
> Countries, too, can't easily import criminal sanctions. A country can adopt stronger rules, but these rules have to fit within an existing legal framework. They can't be adopted wholesale, the way that disclosure rules can be. Moreover, the rules are, in the end, no better than local enforcement.

3. *An honest, sophisticated securities agency (and prosecutors for criminal cases)*
4. *Honest, sophisticated, well-functioning courts*

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

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

5. *An active financial press and securities analysis profession* (company ranking = 3; country ranking = 2)

> For the most part, the financial press must be homegrown. Critical coverage can be chilled by broad libel rules or, if the country is corrupt enough, by cruder threats (and sometimes actions) against offending journalists. At the same time, a country can improve financial reporting by welcoming the international financial press (*Wall Street Journal*, *Financial Times*, *Economist*, and the like). These journals can provide some reporting themselves, and their example can raise local reporting standards. A country can also encourage foreign investment banks to establish local offices.
>
> Companies can encourage coverage by the press and securities analysts, including foreign analysts. Hence the slightly higher ranking (3 instead of 2) for particular companies than for an entire country.

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

> Culture is inherently largely local. Countries can't import it, only hope to grow their own over time.
>
> A company can take some steps to import a culture of disclosure and compliance. It can hire foreigners to sit on its board of directors and work in its financial department. But that helps only so much. Most of the staff will be local, and can hide local skeletons from the foreigners. And the locals' thought processes, as they consider disclosing something they'd rather hide, will be influenced primarily by national

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

culture and expectations, not the perhaps different norms their company has tried to instill.

7. *Good accounting rules*
8. *A good organization to write accounting rules*
9. *Requirements for audited financial statements*

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

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

Transplanting accounting rules and audit requirements is harder for a country than for a single company. A country can adopt foreign accounting rules, including future changes in those rules, and accompanying audit requirements. But the effectiveness of the new rules and audit requirements depends on the sophistication of local accountants. One company can, at some cost, import foreign accountants. A whole country can't. Moreover, implementing international accounting rules and audit requirements requires a substantial number of trained accountants. The country ranking of 3 reflects the difficulty of creating a sophisticated local accounting profession.

10. *A sophisticated accounting profession*
11. *A sophisticated investment banking profession*
12. *Sophisticated securities lawyers*

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

An individual company can hire international accountants, investment bankers, and securities lawyers. This isn't cheap, but can produce reasonably effective reputational intermediation. However, the company's reputation will still lag behind a company in a jurisdiction with strong local enforcement.

An entire country can't piggyback effectively on international reputational intermediaries. It can permit them to enter, compete with local firms, and hire local people, some of whom will later join or start local firms. But building a sophisticated local profession remains a decades-long task, that requires investing in university-level edu-

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

cation, and writing the rules that create demand for these skilled professionals and lead talented young people to choose these professions. That merits a 2 ranking.

13. *A stock exchange with meaningful listing standards and active insider trading surveillance* (company ranking = 5; country ranking = 3)

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

A country that wants to build a stock exchange can import the exchange's rules and trading system, though both will need to be adapted to local laws and local needs. Another potentially feasible strategy, though so far not a popular one, is to build no stock exchange at all, and expect local firms to list abroad. These possibilities make stock exchanges easier to borrow than other reputational intermediaries, warranting a country ranking of 3.

14. *Market transparency* (company ranking = 4; country ranking = 3)

For a company, price transparency can be ensured by listing on a foreign exchange in a country with strong transparency rules and hiring a good registrar, to ensure that share transfers comply with the transparency rules. Yet efforts to achieve these goals often meet technical difficulties. Also, company insiders and local investment bankers, who benefit from nontransparency, often oppose the rules and impede their implementation. Moreover, a country needs to be able to enforce the transparency rules against the exchange and the registrars. On balance, this warrants a company ranking of 4.

The same strategy is largely feasible for a country. One needs transparency rules for the stock exchange(s), rules on when registrars should record share transfers, plus some ability to enforce the rules against the exchange and the registrars. The problem of local enforcement produces a lower country ranking of 3.

15. *An enforced ban on market manipulation* (company ranking = 3; country ranking = 2)

A country can, without great difficulty, adopt a ban on market manipulation. But making the ban effective requires local enforcement. Whether trading is benign or manipulative depends heavily on local facts – on *who* is doing the trading. The country ranking of 2 combines the feasibility of adopting such a ban with the difficulty of enforcing it.

An individual company's efforts to stop manipulation can be aided by the company's internal culture of compliance and by maintaining a good record of trades. That warrants the higher 3 ranking.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

16. *Civil liability risk for accountants*
17. *Civil liability risk for investment bankers*
For each: company ranking = 3; country ranking = 2

A company that offers shares overseas, subject to overseas rules, using international accountants and investment bankers, subjects the accountants and bankers to foreign liability. But proof problems can be severe. Intermediaries are typically liable only if their conduct is culpable—whether the degree of culpability be negligence, gross negligence, recklessness, or intent. Proving culpability, when the facts are local and often hard to uncover, can be a daunting task. Thus, weak local enforcement greatly reduces the liability faced by reputational intermediaries.

A country that wants to create liability for reputational intermediaries can adapt foreign rules establishing liability. But the country may need to change its procedural rules as well, so that small investors can aggregate their claims. Even if all this is done, local enforcement is still hostage to the strength of local courts.

18. *Civil liability risk for insiders*
19. *Civil liability risk for independent directors if they approve gross self-dealing*
For each: company ranking = 2; country ranking = 1

Insiders and independent directors will generally be locals and hold their assets locally—the traceable ones, anyway. In practice, they will be liable (if at all) only under local law. That brings us back to local courts, which aren't transplantable, and local rules, which are only moderately transplantable. In practice, cases where foreign investors have collected damages from locals in institutionally challenged countries, even for egregious behavior, are rare. Most investors don't even try. They simply invest elsewhere the next time. Hence the country ranking of 1.

To be sure, a company's foreign assets are vulnerable to a suit in a foreign country. The company can be delisted from a foreign exchange if it misbehaves. But these exposures are limited and affect insiders and independent directors only indirectly, through the shares they own. Still, this indirect liability warrants a slightly higher company ranking of 2.

20. *Good civil discovery rules and a class action or similar procedure* (company ranking = 1; country ranking = 2)

A precondition for effective enforcement of many local rules on liability of insiders and intermediaries is good local rules permitting civil discovery, a class action or other procedure that lets small individual investors aggregate their claims, and, for self-dealing, the

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

courts' willingness to accept circumstantial evidence as proof of wrongdoing. In practice, borrowing these practices has proven much harder in many countries than borrowing substantive company law or securities rules. This is partly because discovery rules and class actions implicate the entire civil justice system, and partly because regulators with jurisdiction over company or securities law often have no jurisdiction over procedural rules.[34]

This is the only institution for which the country ranking exceeds the company ranking. A country can at least try to adapt foreign discovery and class action rules; an individual company is bound by its country's rules.

21. *Accountant review of the disclosure of self-dealing transactions* (company ranking = 4; country ranking = 2)

22. *Inclusion of independent directors on company boards* (company ranking = 3; country ranking = 2)

A country can establish procedural devices, such as accountant review of disclosure, to control self-dealing. But the procedures may still catch only a fraction of the self-dealing that insiders engage in and then hide. The true independence of nominally independent directors will depend, in significant measure, on cultural norms. And the incentive to self-deal will be strong as long as local enforcement is weak. Hence the 2 country ranking.

A single company can do somewhat better than a country, but is still limited by the sophistication of its accountants, the culture of independence among its directors, and the cultural acceptance of self-dealing by its managers.

23. *Procedural controls on self-dealing transactions* (review by independent directors, noninterested shareholders, or both) (company ranking = 4; country ranking = 3)

A country can adopt procedural rules intended to ensure that self-dealing transactions are approved by noninterested directors or shareholders. But if the disclosure environment is weak, managers may hide transactions or appoint compliant independent directors to approve the transactions. If the court system is weak, shareholder lawsuits in cases where the procedures were violated may fail. The country ranking of 3 combines the feasibility of importing these rules with the difficulty of enforcing them.

34. For example, during recent (2000) corporate governance reform advice to the South Korean government, the Ministry of Justice advised us that adopting a class action procedure was simply not possible, no matter how strongly it might be needed. The legislature had recently rejected a proposal to permit class actions and revisiting this issue was not politically viable. *See* Black, Metzger & O'Brien (2000), *supra* note 6.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

A single company can hire good directors; its managers can follow the company's own procedures. Still, the extent to which this will happen in practice will depend on managerial culture and on the risk that insiders will be caught if they cheat. Hence the company ranking of 4.

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

The analysis here is much the same as for disclosure rules generally. A single company can list on a foreign stock exchange and subject itself to the accompanying disclosure rules. The company and its insiders still may not follow the rules as attentively as (say) an American company, if the insiders have reason to conceal their ownership. Hence the company ranking of 4 instead of 5.

A country has to fit disclosure rules into its overall legal framework and be able to enforce them. For example, if courts don't understand that if Company *A* controls Company *B*, and Company *B* controls Company *C*, then Company *A* controls Company *C*, disclosure rules that work fine in a developed country will break down.[35] The country ranking of 3 reflects this risk.

25. *Enforced securities or other laws banning insider trading* (company ranking = 3; country ranking = 2)

Insider trading can be banned as a formal matter, but policing it is difficult everywhere, and nearly impossible if local institutions are weak. Much of the proof (*A* is related to *B*, who knows *C*, who actually traded) will be local, and thus hard to come by. It helps if a company is listed on a foreign exchange, with an active surveillance operation. But the exchange will usually hit a dead end when it investigates suspicious trading. These enforcement problems produce a 3 company ranking and a 2 country ranking.

CAN SUBSTITUTE INSTITUTIONS FACILITATE PIGGYBACKING?

Some readers of this article have commented that they can imagine new institutions that could partially substitute for weak local regulation. For example, a company can bond its promise to obey another country's high-quality rules by depositing assets in an escrow account with a foreign

35. In Russia, for example, it remains an open issue under the Russian company law whether, if Company *C* is a subsidiary of Company *B*, and Company *B* is a subsidiary of Company *A*, that makes Company *C* a subsidiary of Company *A*. This affects, among other things, whether a transaction between *C* and *A* is governed by the rules that require noninterested shareholder approval of related-party transactions.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

bank, that will be available to satisfy a court judgment. Purchasing a directors' and officers' insurance policy can have the same effect.

Creative efforts to limit local risk can be important. For example, companies in countries with significant political risk sometimes go to great lengths to issue securitized debt in a form that reduces this risk.[36] This suggests that similar efforts could reduce the discount that a company's shares suffer due to weak local regulation.

And yet, such substitutes haven't developed. One possible explanation is that no one has tried hard enough yet. This is a financial innovation, yet to be born. But a competing explanation is that the gains are smaller than the transaction costs of the effort. Today, we can't distinguish between these explanations. But I suspect that if the gains were both large and capturable at modest cost, someone would have developed a way to achieve them.

Consider the escrow account strategy for a company that is raising new capital. The amount of the bond must be only a fraction of the amount of capital the company plans to raise, or else the company will not raise any net investable capital. But a fractional escrow is only fractionally effective in discouraging self-dealing. Second, the escrow will increase capital raising costs. For example, if flotation costs are 10% of the gross amount raised, and 1/3 of the net proceeds are placed in escrow, the company faces flotation costs of 17% of the investable amount raised.[37] Third, tax rules may raise the cost of placing funds in an escrow account. Fourth, language barriers and weak home-country institutions may make it hard for investors to prove self-dealing in order to collect on the escrow. Finally, complex contracting will be needed over the conditions to be satisfied before the escrow can be released.

IMPLICATIONS FOR COMPETITION BETWEEN SECURITIES REGULATORS

A recent literature debates whether firms should be able to choose their securities regulator. This would open up regulatory competition, akin to American competition between states for corporate charters, and could produce disclosure rules that strike a better balance, at the margin, between the costs and benefits of disclosure. Roberta Romano argues that American states should be able to compete to offer disclosure rules; Stephen Choi and Andrew Guzman propose competition among national securities regulators.[38] Merritt Fox responds by proposing national regu-

36. *See* Claire A. Hill, *Latin American Securitization: The Case of the Disappearing Political Risk*, 38 VA. J. INT'L. L. 293 (1998).

37. In this example, for each $100 gross amount raised, the net amount raised is $90, of which $60 is investable. Flotation costs are $10; this is one-sixth (17%) of $60.

38. Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L. J. 2359 (1998); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998).

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

lation of home-country issuers, regardless of where they issue securities; Uri Geiger wants an international superregulator to choose the disclosure rules.[39]

My analysis suggests that this debate is misguided. It focuses primarily on disclosure rules, when the real competition is between complex national systems for fostering disclosure and controlling self-dealing. Disclosure rules are a small part of the network of institutions that support strong disclosure; the securities regulator's role in adopting disclosure rules is not critical to having good rules; and this role is a small part of the regulator's overall job. The core regulatory role is enforcing standards of conduct against issuers and reputational intermediaries who flagrantly violate the disclosure rules, not tweaking the rules at the margin.

Moreover, even on the narrow terrain of disclosure rules, competition is unlikely to produce more cost-effective rules. Companies that face lax local rules can already prepare disclosure to a higher foreign standard if they like. Thus, regulatory competition mostly lets companies that face strict local standards choose more relaxed standards instead. Companies have two possible reasons for doing so—to hide bad results, or to save on accounting costs if the cost of compliance exceeds the benefit to investors of more detailed disclosure. To see which motive is likely to dominate, consider the incentives of a company that wants to save on accounting costs—the case that underlies the pro-competition arguments.

A U.S. company that adopts (say) German accounting, which permits hidden reserves, will suffer a double hit to its share price. It will lose the benefit of comparability with other similar U.S. companies, and investors will assume that it likely has something to hide. This is the same adverse selection effect I have described earlier in this article, in a different guise.

Investors know that, on average, companies that choose less stringent disclosure want to conceal bad results. They will discount these companies' share prices to reflect that risk, even if a company claims that it just wants to cut its accounting costs. After all, that's what every company will claim, whatever its managers' true motives. This price discount will make switching costly for a company that wants to reduce accounting costs, and will cause many potential switchers not to switch. But the price discount won't deter companies with something to hide—as long as the news that they plan to hide is at least as bad as what investors will assume.

This adverse selection effect increases the likelihood that the companies that switch are concealing bad news, and increases the discount that in-

39. Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997); Merritt B. Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 97 MICH. L. REV. 696 (1998), Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999); Uri Geiger, *The Case for the Harmonization of Securities Disclosure Rules in the Global Market*, 1997 COLUM. BUS. L. REV. 241 (1997); Uri Geiger, *Harmonization of Securities Disclosure Rules in the Global Market—A Proposal*, 66 FORDHAM L. REV. 1785 (1998).

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

vestors will apply to the switchers. That further discourages companies from switching to save accounting costs, increases the percentage of bad-news-hiding switchers, and increases the expected amount of bad news they are concealing. This increases the discount that investors will apply to all companies that switch to a laxer disclosure regime, and so on. The adverse selection effect on price is compounded because the fewer companies that switch, the greater the cost to the switchers from losing comparability with non-switching companies.

My own judgment is that the comparability and adverse-selection costs of switching will swamp the modest savings in accounting costs. If so, competition among regulators to issue disclosure rules will permit some companies to hide bad results and won't produce much pressure on rule writers to provide cost-effective rules.

CONCLUSION: WHAT STEPS TO TAKE FIRST

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

Many transition economies have few or none of the core institutions discussed above. Where should they start? There are two obvious places. The first area of emphasis should be on institutions that must be home-grown, including honest courts and prosecutors. Honest courts, regulators, and prosecutors are critical whatever form a country's capital markets take. Government honesty is also important for economic growth quite apart from capital markets development.

A second good starting place is to adopt good capital markets rules. These can, in significant part, be imported from outside. But the importing country needs to understand that if it engages five sets of foreign advisors, they will propose five different laws, which will be inconsistent with each other and with the country's existing laws. Local draftsmen must be closely involved in the drafting process, to ensure that the rules fit into the existing legal framework and build on existing terminology and practice to the extent possible.

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

Another important long-term step, if reputational intermediaries are weak or few in number, is establishing or strengthening professional business schools (for investment bankers and accountants) and law schools (for securities lawyers and regulators). The payoff from training young people

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms

will be measured in decades. But if the investment isn't made, the decades will go by, and the country still won't have the institutions it needs.

In developed countries, scholars often think of good corporate governance as revolving around subtle variations in the independence of directors, the existence and role of the audit committee, constraints on hostile takeovers, and the like. In developed countries, corporate governance is much more basic. These countries need honest judges and regulators, good disclosure rules, and the beginnings of a culture of honesty before it makes sense to worry about independent directors.

This content downloaded from
149.10.125.20 on Sat, 29 Jan 2022 02:49:31 UTC
All use subject to https://about.jstor.org/terms