Experiments in Financial Democracy

Corporate Governance and Financial Development in Brazil, 1882–1950

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Para Haydeé y Humberto

… most of the fundamental errors currently committed in economic analysis are due to lack of historical experience more often than to any other shortcoming of the economist's equipment.

— Joseph Schumpeter, *History of Economic Analysis*, p. 13

C'est une immense démocratie financière qu'on ne rencontre nulle part ailleurs et qui est la force et la sauvegarde de notre pays (It's an immense financial democracy that cannot be found elsewhere and is the force and safeguard of our country)…

— Alfred Neymarck, "Les chemineaux de l'épargne," p. 125,
referring to France

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Preface

When I started to do research for this book, debate about the policies and legal institutions necessary for the development of financial markets around the world was intensifying both in academic circles and in international financial agencies. As academics reached near consensus on the importance of financial development to foster economic growth, the development of financial markets became a goal of international development agencies and governments in most countries. Discussion moved from how important it was to have stock markets versus banks to how countries could develop financial markets in general. To devise policies that could help countries develop financial markets, however, academics and policy makers first had to understand why financial markets are more developed in some countries than in others.

A natural candidate for explaining these differences was variation in legal institutions across countries. But although social scientists agree that institutions are important in explaining economic and financial development, there is no agreement as to which institutions generate, and which are incidental to, financial prosperity. It could be the case, for example, that important changes in institutions and regulations in the already highly developed U.S. financial system were demanded by actors to further improve the functioning of that market. If so, institutions that favor the development of financial markets might be a consequence rather than a cause of financial development.

Researchers therefore sought to explain the variance in financial markets by looking for institutional differences across countries that would not be a consequence of financial market development. The logical way to do this was to go back in history before the emergence of modern financial markets to look for factors that might account for the variation in institutions across countries.

A number of papers that follow this methodological approach argue that contemporary institutional and financial outcomes are a consequence of the persistent effects of the legal traditions countries adopted decades or centuries ago. This literature, termed the "law and finance" literature, advances the idea that a country's legal tradition determines the degree to which the legal system protects investors from the abuses of managers and corporate insiders, and this influences how willing savers are to participate in financial markets and, ultimately, how deep these markets will be. In fact, their statistical work suggests that common law countries (Australia, Canada, England, the United States, and others) have, on average, stronger protections for creditors and shareholders, and larger financial markets, than countries that followed the civil law tradition (Brazil, countries in continental Europe, most of Latin America, and others).

Because most countries adopted or inherited their legal traditions before legislators enacted investor protections, even, in fact, before modern financial markets developed, legal systems are thought to be exogenous to finance. Also implicit in the law and finance literature's statistical results is the notion that there exists a relationship between legal origin and financial market development. If being a civil law country is highly correlated with having smaller financial markets and poor investor protections today, this relationship between legal origin and financial outcomes should be observable at any time in the country's past. Yet, most of the work in this literature has focused on finding relationships between a time-invariant variable such as legal origin and investor protections and financial development, which seem to vary a great deal over time. As I did the research for this book, I found that only a few researchers were looking into the historical trajectories of institutions and financial development over a long time span. I realized that we needed detailed case studies that tracked institutions and markets over time in order to inform our understanding of how, if at all, legal traditions determined the economic development paths countries followed in subsequent years.

As I tried to understand the origins, institutional and otherwise, of the large stock and bond markets that developed in Brazil since the nineteenth century, I realized that the logic employed by the law and finance literature to explain differences in financial market development did not square with my evidence. If the effects of legal traditions persist over time, Brazil should have had weak investor protections in the past as well as today. But my evidence showed that the first period of financial development, roughly between 1882 and 1915, was accompanied by strong investor protections. This suggested a lack of support for the idea of persistent effects of legal traditions. It remained to identify the specific investor protections that aided the development of stock and bond markets after 1882, and to determine how the Brazilian government and Brazilian corporations were able to provide these protections. I found strong creditor rights not only in Brazil, but also in other countries during the nineteenth century, likely due to the influence of Napoleon's commerce code, which led most countries to impose harsh punishments on debtors in default and judges in many countries, especially Brazil, to strongly protect creditors. Because bondholders also benefited from these practices, when corporations were allowed by law to issue bonds, the Brazilian bond market gained momentum. The takeoff in bond markets in Brazil was thus related to legal institutions that protected creditors and court practices that protected bondholders during corporate bankruptcies.

Curiously, I did not find strong protections for shareholders in either the Commerce Code or Brazil's national company laws. Yet Brazil's stock markets enjoyed a bonanza period between 1882 and 1915, and minutes of large corporations' shareholder meetings revealed that in many cases corporate ownership was relatively dispersed and distribution of votes among shareholders relatively egalitarian in many corporations. How was it that these savers, who were not protected directly by national regulations, were willing to invest in Brazilian corporations and showing up in significant numbers at shareholder meetings?

The answer, I found, was that the investor protections absent from national laws were incorporated in the bylaws or provided through the actions of corporations and the information made available to investors before equity was sold in financial markets. I found this also to be the case in other countries in which national protections for investors were weak or absent. For instance, while I was writing this book researchers studying the evolution of stock markets and ownership concentration in Chile, Germany, Italy, Japan, and the United Kingdom showed that in those countries, too, financial markets had grown rapidly at the end of the nineteenth century and beginning of the twentieth century despite the lack of legal protections for shareholders in national laws. Some of these researchers surmised that financial intermediaries such as universal banks and stock exchanges were the source of the trust needed to induce investors to buy the equity and participate in the ownership of publicly traded corporations. The evidence for Chile, England, and Japan was to a large extent similar to that for Brazil: corporations included in their bylaws voting provisions that explicitly protected small investors by limiting, for example, the maximum number of votes per shareholder.

The idea that the kind of investor protections we observe today is a consequence of the legal tradition countries follow stems directly from the way the law and finance literature conceptualizes history. If there are clear and systematic differences in legal protections for investors across countries, and those are strongly correlated with legal origin, then in order to justify the causality from those protections to financial development it must be the case that the systematic differences were determined by legal origin years and years ago. Yet, the evidence presented in this book shows that this is not the case: before 1913 investor protections were very different in Brazil, and perhaps in many countries, from what they are today. History did not occur the way the literature assumes and the only way to know the evolution of investor protections over time is actually to do historical work. Therefore, the first main objective of this book is to defend the use of explicit historical research rather than relying on the merely implicit historical work done by most studies in the law and finance literature. As Joseph Schumpeter argued in his *History of Economic Analysis*, perhaps this is one of those instances in which the use of detailed historical work could aid the development of an economic theory of the relationship between legal institutions and financial development.

The second important contribution of this book is to bring the corporation back into the forefront of the debate about investor protections and access to capital. Most of the literature that studies investor protections and other regulations that promote financial development emphasizes the importance of regulations and government monitoring, relegating companies, shareholders, and mangers to a secondary role. The recipes for developing financial markets promulgated by the law and finance literature are for governments and regulatory agencies (and largely dependent on information disclosure by corporations issuing equity and bonds). According to this literature, which is followed closely by the World Bank and other international organizations, the best way to improve investor protections is through the reform of national company and bankruptcy laws (not to mention influencing judiciary behavior and improving the monitoring capacity of regulatory agencies). Once legal systems (and with them investor protections) are improved, this story goes, masses of new investors will participate in stock and bond markets, which will deepen, causing the cost of capital for corporations to fall.

My historical evidence shows that in the absence of investor protections in national laws, Brazilian companies and their founding shareholders induced smaller investors to buy equity on a massive scale before 1915 through the dissemination of information (e.g., the names and interests of all corporate insiders) and inclusion of friendly provisions in their bylaws. I document, for example, some important provisions in corporate bylaws that limited the power of large shareholders and show how they operated in practice. In fact, corporations with provisions that limited the power of large shareholders exhibited less concentration of ownership and voting power. I found many instances of shareholders who held large portions of equity that afforded them less than proportional voting rights, reflecting, I believe, democratic attitudes on the part of investors and a rooted tradition of "financial democracy" in some of Brazil's largest corporations.

Of course, democratic practices at the company level did not exist in a void of government regulation and oversight. In fact, Brazil had a system of fairly advanced company laws that provided limited liability to shareholders, mandated a two-tier board system, permitted shareholders to sue managers for fraud and mismanagement, and required corporations to make public everything from financial statements and shareholder meeting minutes to executive compensation.

That many of Brazil's largest corporations financed growth through bond issues was a consequence, I maintain, of improvements in creditor rights in 1890 that led to increased investor participation in the bond markets. After that year, the republican government that replaced the Brazilian monarchy started a series of regulatory and constitutional changes. As a consequence of one such reform, bondholders were strongly protected on paper and in practice.

However, the institutional settings that promoted financial development in Brazil were not long lasting. The disruption in trade and capital markets generated by World War I and the subsequent inflation in Brazil and other countries increased the cost of capital for corporations and reduced real returns for investors. The economic shock of World War I and the changes in international markets that followed (especially after the Great Depression) altered the equilibrium that existed until 1914, radically changing corporate governance practices and promoting the rise of bank-based financing for corporations. The book ends with this "great reversal" of conditions and draws some lessons for the future.

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This book is the product of a long effort that benefited from the support and help of many colleagues around the world. To my advisor and friend, Steve Haber, who contributed to the design of this project from its very early stages, I am particularly grateful. Many of the ideas advanced in these pages had their genesis in conversations we had in his office or at the academic seminars and conferences he organized. I am also grateful to Gavin Wright, Zephyr Frank, and Avner Greif at Stanford University, who essentially taught me economic history and kindly gave of their time to discuss many of the ideas that have ended up in this book.

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ONE

Introduction

At the end of 2007, the financial press celebrated that the São Paulo Stock Exchange (Bovespa) had successfully promoted the issue of new shares for 27 companies in that year alone. Abetted by low interest rates and improvements in corporate governance, corporations in Brazil had accomplished what seemed to be an all-time record number of initial public offerings (IPOs) in a single year.[1] Yet, Brazil experienced a period of relative stability in interest rates and intense activity in stock markets before 1920 that by some measures represents even more of an historical peak than today's boom. Many of the better years between 1890 and 1913 saw more than 30 new initial public offerings of stock on the Rio de Janeiro and São Paulo stock exchanges combined. Moreover, both the number of traded companies per million people (a common measure of stock market development) and the capitalization of corporate bond issues to gross domestic product (GDP) were nearly twice at the beginning of the twentieth century than they are today. How did Brazil develop such an impressive market for corporate securities – perhaps even more impressive than today's market – before World War I?

This book examines the institutional conditions that prevailed at the turn of the twentieth century when Brazilian companies were selling large amounts of equity and bonds to foreign and domestic investors. The argument of the book is that in a relatively favorable macroeconomic environment, with significant flows of external capital, Brazilian corporations were able to attract large numbers of shareholders and bondholders by providing protections against potential mismanagement and abuse by managers and insiders. These often took the form of corporate bylaws that constrained

[1] See, for example, "Brazilian Markets: The View from Cloud Nine," *The Economist*, October 27, 2007, p. 88.

the power of large investors and bankruptcy laws that protected the rights of bondholders in the event of default. An important sidebar to this story is that Brazilian investors circa 1900 had access to more detailed information about the ownership and financial health of, and executive compensation in, corporations than is available even to relatively well-informed investors today. Such information was at that time recorded in official documents and reported in the financial press.

These conditions had a significant effect on the country's industrialization because it was through the issue of corporate securities that companies mobilized the resources needed to finance Brazil's earliest development of domestic railways, manufacturing companies, utilities, and banks as well as businesses in other sectors. This book contributes to the historiography of Brazil two important insights. First, its detailed analysis of the development of stock and bond markets in Brazil reveals that financial markets mattered, especially in an environment in which banks focused on short-term lending and the financing of the coffee export complex. Second, Brazil's early industrialization was financed largely through stock and bond issues because Brazilian investors trusted these securities thanks to a complex set of institutions that protected them. A richly detailed narrative of how this institutional system evolved and worked between 1882 and 1950 reveals investor protections to have been stronger at the turn of the twentieth century than one might imagine given the country's relatively "adverse" institutional heritage.[2]

[2] According to recent literature that links current levels of institutional and economic development in excolonies, Brazil at the time of colonization had all the worst possible initial conditions, including an adverse, disease-ridden environment that complicated European settlement, vast expanses of land that encouraged plantation agriculture resulting in a low proportion of European settlers to native and African slaves, and the French civil law system inherited from the Portuguese, which affords only weak protections of investors' rights and enforcement of complex financial contracts. Under these conditions, Brazil should throughout its history have had a weak institutional environment, especially with respect to the enforcement of contracts, and thus low levels of financial and economic development. These initial conditions were related to subsequent levels of institutional and economic development by Daron Acemoglu, Simon Johnson, and James Robinson, "The Colonial Origins of Comparative Development: An Empirical Investigation," *American Economic Review* 91 (2001): 1369–1401. Most of the discussion of the importance of initial endowments was originally developed by Stanley Engerman and Kenneth Sokoloff, "Factor Endowments, Institutions, and Differential Paths of Growth," in Stephen Haber (ed.), *Why Latin America Fell Behind*, Stanford: Stanford University Press, 1997, pp. 260–304. But none of these latter authors attributes a path-dependent effect to these initial conditions, insisting instead that initial conditions would influence but not determine future paths of development (see p. 262).

LAW AND FINANCIAL DEVELOPMENT

There is a general agreement that financial markets matter for economic growth. Among other things, firms and individuals finance their investment and consumption by borrowing from banks, and stock and bond markets connect corporations that need capital to make investments with savers who are interested in high returns and want a diversified portfolio. In fact, economists and economic historians have been able to demonstrate significant causal links between financial development and economic growth. Levels of financial intermediation, stock market liquidity, and banking development, for example, are good predictors of long-run economic growth. There is also evidence that firms that rely more heavily on external sources of finance to expand operations have grown disproportionately faster in countries that have more developed financial markets. What is not so clear is why financial markets are more developed in some countries than in others.[3]

An explanation for differences observed in financial development around the world might logically be sought in variation in institutions across countries. If we think of institutions as a combination of formal (e.g., laws) and informal (e.g., norms, conventions, and cultural beliefs) rules that constrain or enable actions on the part of the economic actors in a society, then the relevant question becomes, Which rules constrain and which enable the development of financial markets?[4]

[3] The finance-growth link has been established by, among others, Raymond W. Goldsmith, *Comparative National Balance Sheets: A Study of Twenty Countries, 1688–1978*, Chicago: University of Chicago Press, 1985; Robert G. King and Ross Levine, "Finance and Growth: Schumpeter Might Be Right," *Quarterly Journal of Economics* 108, 3 (1993): 717–737; Ross Levine and Sara Zervos, "Stock Markets, Banks, and Economic Growth," *American Economic Review* 88 (June 1998): 537–558; Raghuram G. Rajan and Luigi Zingales, "Financial Dependence and Growth," *American Economic Review* 88 (June 1998): 559–586 and "Financial Systems, Industrial Structure, and Growth," *Oxford Review of Economic Policy* 17-4 (2001): 467–482; and Peter L. Rousseau and Richard Sylla, "Financial Revolutions and Economic Growth: Introducing this EEH Symposium," *Explorations in Economic History* 43, 1 (2006): 1–12 and "Emerging Financial Markets and Early U.S. Growth," *Explorations in Economic History* 42, 1 (2005): 1–26.

[4] "[I]nstitutions," according to Douglass C. North, "are the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self imposed codes of conduct), and their enforcement characteristics. Together, they define the incentive structure of societies and specifically economies." See Douglass C. North, "Economic Performance Through Time," Nobel Prize Lecture, Stockholm, December 9, 1993. (Nobel Prize Lecture, December 9, 1993). See also Douglass C. North, *Institutions, Institutional Change, and Economic Performance*, Cambridge: Cambridge University Press, 1990.

Even if social scientists have agreed that institutions are important in explaining economic and financial development, it is not yet clear which institutions generate and which are incidental to financial prosperity. Researchers looking for institutional differences across countries that can explain variation in financial markets, but that are not a consequence of financial market development, have logically gone back in history in search of exogenous factors that might have come into play before the emergence of modern financial markets. This was the approach followed by, among others, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny in a series of papers that belong to what has become known as the "law and finance" literature. They relate financial development to the extent of a country's legal protections for investors (shareholders and creditors), arguing that "when investor rights such as the voting rights of the shareholders and the reorganization and liquidation rights of the creditors are extensive and well enforced by regulators or courts, investors are willing to finance firms."[5] They divide the world into two main legal traditions, civil law and common law, and four legal families, common law, French civil law, German civil law, and Scandinavian civil law. They find that "legal rules protecting investors vary systematically among legal traditions or origins, with the laws of common law countries (originating in English law) being more protective of outside investors than the laws of civil law (originating in Roman law) and particularly French civil law countries."[6] They further argue that because "countries typically adopted their legal systems involuntarily (through conquest or colonization)," legal families can "be treated as exogenous to a country's structure of corporate ownership and finance."[7]

Implicit in the methodological approach used by this literature is the idea that the effects of legal institutions persist over time. If being a civil law country is highly correlated with having smaller financial markets and poorer investor protections today, this relationship should thus be observable at any time in the country's past as well. Even if there is now a larger literature looking at the historical trajectories of institutions and financial development over time, economists and policy makers have largely ignored them, especially when it comes to making policy recommendations. This book contributes to the debate, but rather than focusing only on the evolution of national laws protecting investors, it examines how corporate governance practices evolved at the company level.

ARGUMENT OF THE BOOK

This book argues that the legal traditions adopted or inherited in the past neither determine nor constrain the faith of countries. The evidence presented here shows that there is significant variation in levels of investor protections and financial development over time and calls into question the persistent effects of legal traditions in the long run.

The book explores the significant variation in financial development and, especially, in investor protections in Brazil between 1882 and 1950. After documenting, in Chapter 2, the development of large stock and bond markets in the country between roughly 1882 and 1915, I study the institutional conditions that enabled and supported this development. I show that (1) Brazil had strong protections for shareholders and creditors in the past (perhaps even stronger than today), and (2) the protections enjoyed by shareholders were provided and enforced not by the government through national laws but by corporations and their managers largely through the organizations' bylaws.

These findings draw on and strengthen the findings of Raguram Rajan and Luigi Zingales, who showed, among other things, that circa 1913 French civil law countries had, on average, larger stock markets than common law countries.[8] The contribution of this book to the literature that studies the conditions that promoted financial development across countries is that it clearly explains the protections that both shareholders and creditors received before 1915 based on archival research and company-level data. Chapter 9 uses the Brazilian case to test some of the hypotheses of Rajan and Zingales and others who have explained the decline of stock

I prefer to define institutions as not only "constraints" but also enablers of behavior, an idea advanced by Avner Greif, "Cultural Beliefs and the Organization of Society: A Historical and Theoretical Reflection on Collectivist and Individualist Societies," *Journal of Political Economy* 102, 5 (October 1994): 912–950, especially pp. 915 and 943, and *Institutions and the Path to the Modern Economy: Lessons from Medieval Trade*, Cambridge: Cambridge University Press, 2006.

[5] See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, "Investor Protection and Corporate Governance," *Journal of Financial Economics* 58, 1 (2000): 1–25, quote from p. 5.

[6] For a survey of this literature, see Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "The Economic Consequences of Legal Origins," *Journal of Economic Literature* 46, 2 (June 2008): 285–332, quote from the unpublished version, October 2007, p. 3.

[7] See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, "Law and Finance," *Journal of Political Economy* 106–6 (1998): 1113–1155, esp. p. 1126.

[8] See Raghuram Rajan and Luigi Zingales, "The Great Reversals: The Politics of Financial Development in the 20th Century," *Journal of Financial Economics* 69 (2003): 5–50, esp. Table 3, and *Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity*, New York: Crown Business, 2003, p. 212.

markets across countries after World War I. The main finding is that inflation may have played a strong role in the demise of stock and bond markets. Moreover, inflation and interest rate ceilings explain to a large extent the switch to a system of corporate finance based on bank credit.

Although the evidence for Brazil casts doubt on the idea that the effects of legal tradition on investor protections and financial development persist over time, I do not therefore suggest that the principle advanced in the law and finance literature that investor protections matter does not hold historically. In fact, evidence that investor protections mattered to and aided the development of stock markets before World War I is to be found in most of the chapters of this book.

AGENCY COSTS AND INVESTOR PROTECTIONS ACCORDING TO THE LAW AND FINANCE LITERATURE

The body of scholarly work known as the "law and finance" literature has been instrumental in focusing researchers' attention on investor protections and the legal environment as important determinants of the greater financial development of some countries than others.[9] The main idea advanced by this literature is that investors cannot be expected to participate in financial markets without legal protections because "when outside investors finance firms, they face a risk, and sometimes near certainty, that the returns of their investments will never materialize because the controlling shareholders or managers expropriate them."[10] This book takes this part of the argument of the law and finance literature as given and examines how companies actually provided protections against such risks.

[9] Representative works include: Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, "Legal Determinants of External Finance," *Journal of Finance* 52, 3 (1997): 1131–1150; La Porta et al., "Law and Finance," 1113–1155; La Porta et al., "Investor Protection and Corporate Governance," 1–25; Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "Corporate Ownership around the World," *Journal of Finance* 54, 2 (1999): 471–517; Simon Johnson, Rafael La Porta, Florencio Lopes-de-Silanes, and Andrei Shleifer, "Tunneling," *The American Economic Review Papers and Proceedings* 90 (2000): 22–27; Thorsten Beck and Ross Levine, "Legal Institutions and Financial Development," in Claude Menard and Mary Shirley (eds.), *The Handbook of New Institutional Economics*, Dordrecht, The Netherlands: Springer, 2005, pp. 251–279; Thorsten Beck, Asli Demirgüç-Kunt, and Ross Levine, "Law and Finance: Why Does Legal Origin Matter?," *Journal of Comparative Economics* 31 (2003a): 653–675; "Law, Endowments, and Finance," *Journal of Financial Economics* 70, 2 (2003b): 137–181; and Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, "Economic Development, Legality, and the Transplant Effect," *European Economic Review* 47 (2003): 165–195.

[10] La Porta et al., "Investor Protection and Corporate Governance," p. 4.

The idea that the separation of ownership from control in large corporations generates agency costs goes back to the work of Adolf A. Berle and Gardiner C. Means (*The Modern Corporation and Private Property*, 1967[1932]) and the formalization of the theory of the firm by Michael C. Jensen and William H. Meckling, among others.[11] In Jensen and Meckling's view, the agency costs (or conflict between the respective interests of shareholders and "insiders") arise because the decisions of the agent or manager running the company for the shareholders will be based not only on

> the benefits he derives from pecuniary returns but also [on] the utility generated by various non-pecuniary aspects of his entrepreneurial activities such as the physical appointments of the office, the attractiveness of the secretarial staff, the level of employee discipline, the kind and amount of charitable contributions ... a larger than optimal computer to play with, purchase of production inputs from friends, etc.[12]

More recently, this view was nuanced to include the fact that controlling shareholders, the "insiders," have incentives to steal profits directly – to, for example, "sell the output, the assets, or the additional securities in the firm they control to another firm they own at below market prices," take advantage of outside investors by giving managerial positions to unqualified family members, obtain inflated salaries for themselves and for other executives, or use the company's private jet for personal jaunts.[13]

Therefore, the theory goes, investors and banks are willing to finance firms as shareholders or creditors in exchange for the power to limit the abuses of directors and insiders. Agency costs, according to the theory, can be reduced by effectively monitoring management (as by requiring disclosure) or devising contracts that align the incentives of managers and outside investors, whether creditors or shareholders (as by awarding stock options to managers who increase the value of the company). Other important

[11] See Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property*, New York: Hartcourt, Brace & World, Inc., rev. ed., 1967 [1932]; Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3, 4 (October 1976): 305–360; Oliver Hart and John Moore, "Property Rights and the Nature of the Firm," *Journal of Political Economy* 98, 6 (December 1990): 1119–1158; and Oliver Hart, *Firms, Contracts, and Financial Structure*, Oxford: Clarendon Press, New York: Oxford University Press, 1995. On the rise of managerial capitalism, see Alfred D. Chandler, *The Visible Hand: The Managerial Revolution in American Business*, Cambridge, Mass.: Belknap Press of Harvard University Press, 1977, esp. Ch. 3 and 12.

[12] Jensen and Meckling, "Theory of the Firm," p. 312.

[13] La Porta et al., "Investor Protection and Corporate Governance," p. 4.

provisions identified in the law and finance literature that can strengthen the position of outside investors relative to managers and insiders include the right to "change directors, to force dividend payments, to stop a project or a scheme that benefits the insiders at the expense of the outside investors, to sue directors and get compensation, or to liquidate the firm and receive the proceeds," and restrictions on voting rights that preclude the disproportionate exercise of power by insiders or managers.[14] In fact, in the United States, the evidence at the firm level suggests that companies with weaker protections for shareholders have lower returns for investors, perhaps because of the larger agency costs.[15]

The law and finance literature maintains that because shareholder and creditor protections provided at the company level are often embodied in financial contracts or company bylaws that, because of their exceeding complexity, impede enforcement by the courts, such provisions instead should be written into national company, bankruptcy, and securities laws, and, indeed, research has found financial markets to be more developed in countries that have legislated more shareholder and creditor protections.[16] The literature classifies countries in terms of how many basic shareholder and creditor protections are incorporated into national laws. It considers these basic rights to include for shareholders the right to vote (one-share, one-vote provisions), to participate in shareholders' meetings, to challenge director or insider decisions, to subscribe new issues of stock to preserve their share of ownership, and to call extraordinary shareholders' meetings, among other provisions aimed at ensuring opportunities to participate in decision making. The literature includes among basic rights for creditors the rights to claim collateral in the event of default, of seniority during bankruptcy, to control company assets during bankruptcy, and to nominate new managers. Investors also require access to accurate financial information and so are concerned about disclosure and accounting rules that provide information they need to exercise other rights.

Incorporation of these investor protections in national laws has been found to be highly correlated with a country's legal tradition.[17] Moreover, countries that follow the common law legal tradition currently provide stronger protections for investors than do countries that follow any of the three civil law traditions (French, German, and Scandinavian), and currently French civil law countries have been observed to have the worst protections for investors and smallest financial markets.[18] "[C]ommon law countries give both shareholders and creditors – relatively speaking – the strongest, and French civil law countries the weakest, protections. German civil law and Scandinavian civil law countries generally fall between the other two."[19] Common law countries also have been found to have more developed equity and debt markets than do any of the civil law countries, and French civil law countries have the least developed financial markets, no matter what measure of financial development is used. A description of the basic features of each of the legal families is in Table 1.1.

In countries with national laws that afford only weak protections for investors, ownership of large corporations tends to be more concentrated.[20] Concentrated ownership is an expected outcome in the face of high agency costs and weak investor protections for at least two reasons. First, because smaller outside investors would be disinclined to participate in the ownership of a corporation from which managers and insiders have unrestricted power to "extract value" for their private benefit, entrepreneurs likely would have to provide the bulk of financing, which would effectively concentrate ownership. Second, ownership concentration can compensate for weak investor protections inasmuch as shareholders with large blocks of votes will have both the incentive and the power to monitor, dismiss, and name new managers.

This book uses the basic approach of the law and finance literature to explore the relationship between investor protections and financial development in Brazil. Yet it challenges the idea that investor protections are stronger or weaker (on paper and in practice) according to the legal tradition of a country and looks for other explanations for how investor protections arose and became relatively strong in Brazil at the turn of the twentieth century.

Other recent additions to the law and finance literature tie financial development more strongly to the degree to which a country's legal system relies on case law and facilitates the adaptation of laws to new market conditions. For instance, according to some of this literature German and Scandinavian civil law rely more heavily than does French civil law on judicial interpretation of statutes and are, thus, more adaptable to changing conditions. According to this logic, common law countries have more

[14] La Porta et al., "Investor Protection and Corporate Governance," p. 5.

[15] See Paul Gompers, Joy Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," *Quarterly Journal of Economics* 118, 1 (February 2003): 107–155.

[16] La Porta et al., "Legal Determinants of External Finance" and "Law and Finance."

[17] This argument was initially developed in La Porta et al., "Legal Determinants of External Finance," "Law and Finance," and "Investor Protection and Corporate Governance."

[18] See, for instance, La Porta et al., "Law and Finance," Tables 2 and 4.

[19] See, for instance, La Porta et al., "Law and Finance," p. 1116.

[20] La Porta et al., "Corporate Ownership around the World."

Table 1.1. *Main features of the four legal families according to the law and finance literature*

Legal tradition	Main features
French civil law	Legal family in which the application of the law is based on the rules established in codes and statutes that were created by legislatures.[a] This form of civil law emerged after the French Revolution and is based on the codification of Roman law by Justinian (6 A.D.), who "took the view that what was in his compilation would be adequate for the solution of legal problems without the aid of further interpretations or commentary by legal scholars."[b] This legal system was also reaction to the power that French judges had before the French Revolution. According to comparative lawyer John H. Merryman: "Before the French Revolution, judicial offices were regarded as property that one could buy, sell, and leave to one's heir on one's death," and "judges were an aristocratic group who supported the landed aristocracy against the peasants and the urban working and middle classes, and against the centralization of governmental power in Paris."[c] Thus, Napoleon, in an attempt to put the state above the courts, suppressed the lawmaking capacity of judges and limited their discretion to the pure application of what was in the codes and statutes passed by legislatures. As a way to reduce judge discretion and corruption, these reforms also included more procedural formalism that in the long run generated an inefficient legal system.[d] Different codes were passed during the Napoleonic era and the French civil law tradition was diffused to other parts of the world throughout the nineteenth century by colonization and cultural influence, reaching the Near East, some parts of Africa, Indochina, Oceania, the French Caribbean, some Swiss cantons, and Luxembourg. Other areas of influence were Spain, Italy, Belgium, Portugal, and their colonies.
German civil law	This legal family was part of Bismarck's effort to unify the legal system of Germany after 1871. Most of the codes were created in the next two decades, mostly modifying the main procedures of French civil law but allowing jurisprudence a more central role. It was created with the idea that "lawyers would be needed" and that "they would engage in interpreting and applying the law, and that the code they prepared should be responsive to the needs of those trained in the law."[e] German civil law, then, intended to incorporate the principles of German legal tradition, which gave much weight to interpretation of the law and precedent (very much in the spirit of common law) and the principles of French civil law and the Roman tradition with comprehensive codes to regulate all areas of law. This legal tradition prevails in Germany, Austria, Czechoslovakia, Greece, Hungary, Switzerland, Yugoslavia, Japan, Korea, China, and Taiwan.
Common law	The main feature of common law is that the judges are the main source of law (precedent determines the law). Codes are also used in the common law world, but experts in comparative law argue that "where such codes exist, they make no pretense of completeness. The judge is not compelled to find a basis for deciding a given case within the code."[f] The main advantage of having law emerging from cases or precedent is that judges can, supposedly, adapt the legal system more rapidly to changing conditions. According to the law and finance literature, one difference of common law and French civil law is that after the Glorious Revolution of 1688 (in England) the law was placed above the Crown in order to limit its power to alter property rights. Thus this legal system is focused on the protection of private property rather than on trying to assert the power of the state over the legal system. The countries that follow the common law tradition are the United Kingdom and all of the former British colonies.
Scandinavian civil law	Scandinavian civil law is less derivative of Roman law (codified law) than are the French and German families. Since it evolved independently from the other legal traditions in the seventeenth and eighteenth centuries, it relies less on codified law and more on precedent or jurisprudence.
Exceptions and hybrid systems	The law and finance literature has ignored the fact that in most countries that follow the civil law tradition judge-made law or jurisprudence is indeed important. Also, most commercial, bankruptcy, and corporate law in common law countries is regulated through national codes rather than purely on the basis of precedent. Furthermore, many countries have hybrid legal systems. For instance, Japan followed German law before World War II and then adopted more features of common law; the Netherlands follows a variation of Roman law called Roman-Dutch law with influences from French civil law; South Africa has a mixture of common and Roman-Dutch law; China adopted the German codes in the late nineteenth century (e.g., the Company law in 1904), but kept many features of Chinese legal practice (common law); and in jurisdictions such as Quebec, Louisiana, and Puerto Rico common law and French civil law operate simultaneously.

Notes:

[a] Jurisprudence plays an important role in the evolution of laws in French civil law countries, even if the law and finance literature tends to ignore it.

[b] John Henry Merryman, *The Civil Law Tradition*, Stanford: Stanford University Press, 1985, p. 7. Other legal traditions that influenced the first codes of French civil law were cannon law and commercial law.

[c] John Henry Merryman, *The Civil Law Tradition*, p. 15.

[d] For a summary of the characteristics of each legal family and the origins of French civil law see Thorsten Beck and Ross Levine, "Legal Institutions and Financial Development," in Claude Menard and Mary Shirley (eds.), *The Handbook of New Institutional Economics*, Dordrecht, The Netherlands: Springer, 2005, pp. 251–279, especially p. 254–255. On the issue of excessive formalism and the effects that can have other important markets (e.g., credit markets) see Simeon Djankov, Rafael La Porta, Florencio Lopez de Silanes, and Andrei Shleifer, "Courts: The Lex Mundi Project," *Quarterly Journal of Economics* 118, 2 (May 2003): 453–517.

[e] John Henry Merryman, *The Civil Law Tradition*, p. 31.

[f] John Henry Merryman, *The Civil Law Tradition*, p. 32.

flexible and adaptable legal systems because judges are the most important source of changes to laws.[21]

This idea has been taken further to suggest that countries that do not adapt their adopted legal system to local conditions and provide flexibility in the interpretation of the statues will find it more difficult to have a strong rule of law. The research in this stream of the literature has been more historical and has looked at how during the nineteenth century many countries, for example in Latin America, copied European codes of commerce and later adapted them to local conditions.[22]

More recently, the debate within the law and finance literature has shifted away from investor protections in national laws (and the importance of public enforcement) and toward the conditions that facilitate private enforcement of shareholder (and creditor) rights. Work by Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer acknowledges, for instance, that "public enforcement plays a modest role at best in the development of stock markets", because what seems to induce investors to buy equity is "extensive disclosure requirements and a relatively low burden of proof on investors seeking to recover damages resulting from omissions of material information from the prospectus [of a new stock issue]," which implies that even in the absence of strong protections in national laws, investors can gauge the trustworthiness of a stock issue as long as its prospectus discloses detailed information about the firm's directors and their ownership shares as well as pertinent financial information. This book agrees with this part of the literature and in fact provides supporting evidence that private

[21] See, for instance, Beck et al., "Law and Finance," 653–675; "Law, Endowments, and Finance," 137–181.

[22] According to Berkowitz et al., the determinants of the level of legal order are related to the degree to which a country is an originator (e.g., France, Germany, England) or recipient of a legal system. A recipient or *transplant* is a country that inherited or adopted its legal system from an originator country. *Transplants* can be either *receptive* (i.e., able to adapt the legal system to local conditions and practices) or *unreceptive* (i.e., adopt the law with little adaptation to local customs and traditions). The hypothesis of such studies is that *receptive transplants* and originators tend to have a stronger rule of law than *unreceptive transplants,* legality being defined in terms of indices of perceived contract enforcement by country. Among *receptive* countries, the United States, in playing a special role as an innovator in commercial law, enjoys a higher level of "legality" than an *unreceptive transplant* country such as Brazil. Katherina Pistor, Yoram Keinan, Jan Kleinheisterkamp, and Mark West are more specific, classifying recipient countries according to the degree to which they adapted their legal systems to local conditions (even analyzing in detail the evolution of the codes of the countries they discuss). See Berkowitz et al., "Economic Development, Legality, and the Transplant Effect," 165–195; and Katharina Pistor, Yoram Keinan, Jan Kleinheisterkamp and Mark West, "Innovation in Corporate Law," *Journal of Comparative Economics* 31, 4 (2003): 676–694.

enforcement (as well as public) was crucial for the development of Brazil's capital markets.[23]

What is less clear for the Brazilian case is whether there is a clear correlation between the conditions that facilitate the private enforcement of shareholder and creditor rights and legal origins. For instance, the work of La Porta and coauthors looking at the private enforcement of investor protections argues that their "findings further clarify why legal origin predicts stock market development" because "the benefit of common law ... appear to lie in its emphasis on private contracting and standardized disclosure and in its reliance on private dispute resolution using market-friendly standards of liability."[24] This book shows that the same facility to enforce equity contracts existed in Brazil at the turn of the twentieth century.

CHALLENGES TO THE LAW AND FINANCE LITERATURE

There has been a significant pushback against the law and finance literature from at least two camps. First, historians and economic historians have done more historical work examining the evolution of investor protections, company laws, and corporate governance practices in general. The findings of these works show that corporate governance in both common and civil law countries varies significantly over time. By focusing mostly on the rights of equity holders, the literature has challenged the idea that there is path dependence between legal origins and investor protections.

The findings of this book confirm this line of argumentation and add two new elements. The first one is that we observe variation over time not only in the rights of shareholders, but also in the protections creditors had in Brazil. Second, the book argues that perhaps the main source of variation in shareholder protections over time exists at the corporate level – in the type of protections companies include in their company bylaws – rather than in national laws.[25]

[23] Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer. "What Works in Securities Laws?" *Journal of Finance* 61, 1 (February 2006): 1–32, quote from p. 20.

[24] La Porta et al., "What Works in Securities Laws?," p. 22.

[25] Some representative works examining the historical trajectories of corporate governance institutions are Naomi Lamoreaux and Jean-Laurent Rosenthal, "Corporate Governance and the Plight of Minority Shareholders in the United States before the Great Depression," in Edward Glaeser and Claudia Goldin (eds.), *Corruption and Reform,* Chicago: University of Chicago Press, 2006, pp. 125–152; Colleen Dunlavy, "Corporate Governance in Late-19th Century Europe and the U.S.: The Case of Shareholder Voting Rights," in Klaus J. Hopt, H. Kanda, Mark J. Roe, E. Wymeersch, and S. Prigge (eds.), *Corporate Governance: The State of the Art of Emerging Research,* Oxford: Clarendon Press, 1998, pp. 5–39; Eric

The second pushback against the law and finance literature comes from a growing number of works in the political economy of finance and the literature on political institutions and financial development. The main idea of this work is that financial development is generated or hindered by policies and regulations that are the products of political interactions. The literature can be divided into two segments: the political economy view and the political institutions and financial development view.

In the political economy view, the interaction of interest groups and the relative power they have determines what kind of financial regulation and investor protections governments put in place and, thus, determines the extent to which a country can develop deep stock and bond markets (as well as large banking systems). For instance, Mark Roe, Raghuram Rajan and Luigi Zingales, Marco Pagano and Paolo Volpin, Enrico Perotti and Ernst-Ludwig von Thadden, and Peter Gourevitch and James Shinn have different political economy models to explain how investor protections in national laws and the configuration of corporate finance are the product of politics (mostly in developed countries). According to these models we need to understand the political process and the shocks that caused a change in the preferences of powerful interest groups in order to comprehend the divergence in investor protections and corporate governance regimes across countries.[26]

The literature on political institutions and financial development argues that the configuration of the political system has a direct impact on the capacity of governments to commit to protect property rights and enforce financial contracts. Beginning with the seminal paper by Douglass C. North and Barry Weingast, there is a large literature linking political systems that

constrain the executive (through a functioning system of checks and balances) with more developed financial markets. The basic logic behind this literature is that a government strong enough to uphold and enforce property rights is also strong enough to expropriate its citizens. Therefore limited governments can credibly commit to enforce financial contracts and protect the (property) rights investors have to the cashflows and assets of companies that trade stocks and bonds.[27]

This book agrees with the view that both politics and political institutions are crucial to understand the configuration of financial systems at any point in time. Without basic protections for property rights and strong court enforcement of financial contracts Brazilian companies could not have committed credibly to protect investors by adding specific bylaws in their corporate charters. A basic legal and political infrastructure had to be in place for Brazilian companies sucessfully to attract investors to buy their shares and bonds. Yet the argument of this book is that companies can partly overcome some of the shortcomings of a country's legal system and political institutions by protecting investors in their corporate bylaws. Governments do not have to protect investors explicitly in national laws; companies can offer those protections in their bylaws, but courts have to be committed to enforce such contracts if a problem arises. Obviously an unconstrained government that can expropriate a company or its shareholders will make it unattractive for investors to buy shares or bonds, notwithstanding the attractiveness of a company's bylaws. In sum, this book borrows heavily from the political economy view and the political institutions and financial development view when it discusses the general framework under which Brazilian companies offered protections for investors, but goes further by saying that a limited government is not sufficient to develop equity and bond markets. Brazil had a limited government (a constitutional monarchy) from independence in 1824 all the way to 1888 and the country did not develop large markets for private securities until the legal system facilitated the private enforcement of property rights.[28]

Hilt, "When Did Ownership Separate from Control?: Corporate Governance in the Early Nineteenth Century," *Journal of Economic History* 68, 3 (September 2008): 645–685; Randall Morck (ed.), *A History of Corporate Governance around the World: Family Business Groups to Professional Managers* (National Bureau of Economic Research Conference Report), Chicago: University of Chicago Press, 2004; Julian Franks, Colin Mayer and Hannes F. Wagner, "The Origins of the German Corporation: Finance, Ownership and Control," *Review of Finance* 10, 4 (2006): 537–585. Unpublished detailed historical work includes Gonzalo Islas Rojas, "Does Regulation Matter?: An Analysis of Corporate Charters in a Laissez-faire Environment," unpublished manuscript, University of California Los Angeles, September 2007.

[26] See Rajan and Zingales, "The Great Reversals"; Mark J. Roe, *Political Determinants of Corporate Governance,* New York and Oxford: Oxford University Press, 2003; Marco Pagano and Paolo Volpin, "The Political Economy of Corporate Governance," *American Economic Review* 95, 4 (September 2005): 1005–1030; and Enrico Perotti and Ernst-Ludwig von Thadden, "The Political Economy of Corporate Control and Labor Rents," *Journal of Political Economy* 114, 1 (2006): 145–175.

[27] See Douglass C. North and Barry Weingast, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth Century England," *Journal of Economic History* 49 (1989): 803–832, and the collection of essays in Stephen Haber, Douglass C. North, and Barry Weingast (eds.), *The Politics of Financial Development*, Stanford: Stanford University Press, 2007.

[28] The argument that Brazil had a limited government throughout most of the nineteenth century and did not develop a large stock market is defended with detailed quantitative evidence by William R. Summerhill III in "Sovereign Credibility with Financial Underdevelopment: The Case of Nineteenth-Century Brazil," unpublished manuscript, University of California, Los Angeles, May 2007.

This book thus borrows heavily from the historical and the political economy approaches and synthesizes the evolution of investor protections and the financial development of Brazil over time. The main objective is to provide new insights that should inform not only policy makers, but also corporate managers interested in improving corporate governance standards in their firms.

THE BRAZILIAN CASE: TIME PRESENT AND TIME PAST

Using Brazil as a case study through which to explore the link between legal origin and investor protections makes sense because it is currently a French civil law country with somewhat poor shareholder protections, a terrible profile of creditor rights, and weak contract enforcement. If we believe that the effects of legal traditions persist over time, we would not expect Brazil to have had better institutions in the past.

Yet, there is clear evidence that Brazil was more financially developed in the past than it is today, especially regarding investor protections. First, both the ratio of the stock of corporate bonds to GDP and number of traded corporations per million people (a common measure of financial development) were larger before 1920 than they are today. Second, shareholder protections at the company level were stronger in the past, resulting in less concentrated ownership of large corporations before 1940 than exists today. Third, Brazil's bankruptcy laws were more protective of creditors and small shareholders at the turn of the twentieth century than is the case today.

An examination of Brazilian corporate governance practices at the end of the twentieth century reveals that controlling shareholders enjoyed the largest private benefits of control in the world as measured by the premium paid for blocks of shares with control rights (to total market value) relative to noncontrolling shares at the time control changes.[29] It is estimated that at the end of the 1990s, shareholders who controlled a Brazilian corporation could, because they had "the ability to transfer corporate assets on non-market terms [to their own businesses or families] or consume perquisites at the expense of the firm," extract in excess of 10 percent of the total value of the company for their private benefit.[30] Other frequently cited signs of weak investor protections in Brazilian corporations include concentrated ownership of voting shares and the existence of nonvoting shares, the latter having no representation on the board of directors and earning no compensation when the control block of the company is transferred to a new outside investor (i.e., no tag-along rights).[31]

This book shows that shareholder rights included in Brazil's national corporate laws were weak before 1940 and only a few of the shareholder protections that the law and finance literature considers relevant for the development of equity markets existed. Hence, the development of stock markets was enabled and supported by the relatively strong protections accorded to shareholders in company bylaws.[32] Financial market development also has been observed in other countries with only weak investor protections at the national level; Great Britain's stock markets evolved rapidly after 1890 and Germany developed a significant equity market after 1930.[33]

Corporate bylaws that induced investors to buy stock included provisions that protected investors' rights in shareholder meetings, limited the power of directors and insiders, and mandated voting schemes that promoted the democratization rather than concentration of control. Provisions that capped the maximum number of votes per shareholder and graduated voting schemes whereby the number of votes did not increase in direct proportion to the number of shares held, thereby limiting the power of large shareholders, were not uncommon.[34] These types of protections were simple enough that any commercial judge could have enforced them.

[29] For a general discussion of the private benefits of control in Brazil or in comparative perspective, see Luigi Zingales and Alexander Dyck, "Private Benefits of Control: An International Comparison," *Journal of Finance* 49 (April 2004): 537–600.

[30] Tatiana Nenova, "Control Values and Changes in Corporate Law in Brazil," paper presented at the European Financial Management Association Meetings, London, 2002, esp. page 1 and estimates of benefits in Section 3. For a general discussion of the private benefits of control in Brazil or in comparative perspective, see Zingales and Dyck, "Private Benefits of Control," 537–600.

[31] For a recent look at corporate governance in Brazil, see Ricardo P. C. Leal and André Carvalhal da Silva, "Corporate Governance and Value in Brazil (and in Chile)," in Alberto Chong and Florencio López-de-Silanes, *Investor Protection and Corporate Governance: Firm Level Evidence Across Latin America*, Stanford: Stanford University Press and Inter-American Development Bank, 2007, pp. 213–287, esp. p. 215.

[32] See La Porta et al., "Legal Determinants of External Finance," 1131–1150.

[33] For the case of Great Britain, see Julian Franks, Colin Mayer, and Stefano Rossi, "Ownership: Evolution and Regulation," Institute of Finance and Accounting Working Paper FIN 401, London Business School, 2004, pp. 3–4, and Pistor et al., "Innovation in Corporate Law," p. 676–694. The German case is discussed in Franks et al., "The Origins of the German Corporation," 537–585, esp. p. 2 for the argument that both the United Kingdom and Germany developed equity markets despite the lack of shareholder rights in their national company laws.

[34] Eric Hilt shows that these kinds of investor protections were common in the charters of manufacturing firms in New York in the first half of the nineteenth century. See Hilt, "When Did Ownership Separate from Control?," 645–685.

The case of Brazil is also used to demonstrate that neither the level of protection accorded shareholders in national laws nor the provisions for disclosure and protection of shareholder rights contained in private contracts seem to be correlated in any way with the legal tradition a country follows. Brazilian law after 1891 required that stock issuers disclose all information that could help shareholders monitor firm activities. Investors had access not only to detailed financial statements, but also to complete shareholders lists detailing the voting power of each shareholder, and even precise figures for executive compensation.

Table 1.2 summarizes some of the differences between the law and finance approach and the approach suggested by the current book, for simplicity called the practice and finance approach because it stems from corporate practices rather than purely from laws and regulations. The main argument of the law and finance literature is that investor protections matter in order to have more savers purchasing equity and bonds. This book is in complete agreement with that part of their argument, but suggests that most of the protections for shareholders actually can be included in corporate statutes. The fact that investor protections were included in corporate statutes rather than in national laws does not mean that the mechanisms to enforce such contracts were purely private. Brazilian courts stood ready to enforce the rights of investors and because of this threat companies respected those contracts.

Another key point is that this book is not a story about how the government monitored companies or about how private actors and the government solved the "commitment problem" and "tied" the hands of the government to prevent it from expropriating private investors. This commitment problem was solved in Brazil very early in its independent life when the constitution of 1824 created a limited government. Rather, the book is about the emergence and demise of the institutions that allowed corporate governance and finance to protect investors against the expropriation of insiders and managers.[35]

There was an instance, however, in which government monitoring was particularly important to increase the trust investors had in private securities. Many companies in Brazil enjoyed government-guaranteed dividends. These guarantees generated trust by virtue of both the subsidy and the accompanying monitoring the federal and state governments did of the corporate accounts of the companies that enjoyed such guarantees.

Table 1.2. *Comparison of the sources of shareholder protections in law and finance vs. practice and finance*

Shareholder protections	Law and finance	Corporate practice and finance
Voting rights	National company laws should have one-share, one-vote for all companies	Company statutes include different voting provisions. The most effective provisions to reduce the power of large shareholders are those limiting the number of votes per shareholder
Minority shareholders are represented on the board of directors	National company laws	Company statutes
Right for small investors to challenge directors' decisions or allow them to leave the company and receive compensation	National company laws	Company statutes
Incumbent shareholders have the first right to buy new stock to avoid dilution of their holdings	National company laws	Company statutes
Disclosure of salaries for all directors	Not explicitly mentioned	Company statutes
Financial disclosure	National company laws	National company laws
Disclosure of deal behind the initial public offering of stock (including names of insiders and promoters)	National company laws	National company laws
Fines and criminal punishments for fraudulent practices by company insiders, founders, and promoters	National company laws	National company laws

Investors in corporate bonds were accorded other kinds of protections, among them strong creditor rights included in bankruptcy laws and strict enforcement of those rights by commercial courts. The cases studied

[35] For a good explanation of the commitment problem and how this commitment was solved in England after the Glorious Revolution see North and Weingast, "Constitutions and Commitment," 803–832. For an explanation of how the Brazilian government solved the commitment problem in the 1820s see Summerhill III, "Sovereign Credibility with Financial Underdevelopment."

in the course of documenting the evolution of creditor rights and court enforcement since 1850 reveal many instances of commercial courts enforcing bondholders' rights. That bond markets in Brazil enjoyed a historical peak in activity between the late 1880s and 1913 is largely attributable to these protections coupled with favorable economic conditions.

Just as it was shareholder and creditor rights provided at the company level and not the persistent effects of Brazil's French civil law tradition that facilitated the development of the country's prosperous stock and bond markets, so the decline of these markets after 1915 was a response not so much to any legal variable as to the rapid fall in international capital flows, which reduced the supply of funds available to Brazilian corporations and destabilized the country's monetary policy. The instability occasioned by the postwar decline in capital imports and coffee exports translated into higher inflation and lower real returns for investors. As the interests of investors in stock and bond markets declined it was easier to change national laws in a prejudicial way for investor protections, undermining the conditions that helped financial markets thrive before 1915.

The corporate landscape of Brazil changed significantly in the 1940s with the rise of state owned and controlled enterprises (SOEs) and the increasing consolidation of national corporations into business groups. Over the course of a couple of decades, widely held companies all but disappeared from the list of Brazil's largest corporations, which had become dominated by family-owned and -controlled business groups and SOEs. Concentrated ownership and weak protections for small investors became the rule in Brazil at least until the turn of the twenty-first century.

The argument I make here is not that Brazil should do whatever is necessary, including reinstating investor protections from the past, to reproduce the conditions that were responsible for the country's golden era of financial development with the expectation that that will bring it back. Rather, I suggest that the lessons taken from this historical episode can inform today's efforts to improve the state of corporate governance practices in Brazil and other countries, including the United States. Whereas in many countries, again including the United States, reform has been pursued through stronger regulation, in Brazil change mostly has taken the form of more intense monitoring by the regulatory agency, the Commisão de Valores Mobiliários (CVM), and self-regulation at the São Paulo Stock Exchange. It is generally accepted that protections for smaller shareholders need to go beyond improving disclosure requirements, assuring voting rights, and reining in abuses by insiders. What, then, might today's regulators and companies learn from this book that might help them further improve protections for small shareholders and induce larger numbers of savers to buy corporate securities?

The first lesson is about disclosure and transparency of corporate ownership. As Justice Louis Brandeis observed in his 1914 book, *Other People's Money*, "sunlight is said to be the best of disinfectants; electric light the most efficient policeman." Brazilian corporations interested in attracting larger numbers of small investors should make an effort to be transparent, not only in financial statements, but also with respect to ownership and control within the firm, right down to details of executive compensation. All of this information was required to be publicly disclosed during the pre-1950 period and was heavily relied upon by investors. Thanks to more than one hundred years of improvements in accounting, financial disclosure by publicly traded corporations today is obviously significantly more sophisticated, yet disclosure of ownership and voting power within corporations is limited to only the largest shareholders, and it can be exceedingly difficult to establish the ownership of some Brazilian corporations given the preponderance of cross-ownership structures called pyramids whereby control of a corporation is in the hands of another corporation that is, in turn, controlled by either yet another corporation or a family.[36]

The second lesson is that voting rights matter and that one-share, one-vote provisions are *not* the only way to democratize ownership. One of the most powerful explanations for why Brazil had large, widely held corporations before 1940, especially before 1910, is that many of the largest Brazilian corporations, conscious of the importance of attracting and protecting small investors, drafted corporate bylaws that included voting provisions that limited the power of large shareholders through either caps on the maximum number of votes per shareholder or graduated voting schemes that reduced the power of large investors as their shareholdings increased. In Chapter 5, I show that ownership concentration was significantly lower in corporations that had such voting provisions than it was in the average Brazilian company before 1940. A further difference is that before 1932 no shares were automatically excluded from voting (as preferred shares later were). In principle, before 1932 all the shareholders had the right to vote.

In sum, the actions of corporations matter because investor protections at the company level matter. Companies can indeed overcome some of the shortcomings of the legal systems in which they operate if they provide

[36] In fact, academics get credit for reconstructing some of the pyramidal ownership schemes in Brazilian corporations. See, for instance, Leal and da Silva, "Corporate Governance and Value in Brazil," pp. 213–287.

investor protections beyond what is legally mandated. This is how companies in Brazil, and in other countries such as Japan, the United States, and England, did it in the past. In fact, today an important literature published in journals of accounting and international business has been pushing the idea that it pays for companies to have better corporate governance than what is minimally mandated by the law, not only as a way to attract investors and facilitate access to foreign capital markets (a huge incentive for fast-growing firms), but also to send a signal to qualified labor that governance is relatively transparent and more democratic than the norm. According to Tarun Khanna and Krishna Palepu, this is one of the reasons Infosys, an Indian software giant, has been so successful in attracting foreign capital as well as talented and highly trained software engineers.[37]

Moreover, the findings of this book are in line with the findings of the literature of voluntary financial disclosure. For instance, Paul Healy and Krishna Palepu argue that "managers who anticipate making capital market transactions have incentives to provide voluntary disclosure to reduce the information asymmetry problem, thereby reducing the firm's cost of external financing."[38] That is, in some contexts companies are better off providing more information than what is mandated by law. In Brazil, companies in which shareholders faced a lower agency cost because of such protections attracted a large number of shareholders and ended up with lower concentration of ownership.

These lessons do not necessarily apply to all corporations at all times. They are lessons that travel and apply to corporations for which issuing equity is cheaper than obtaining a loan or using internally generated savings (retained earnings). Sharing power with more investors, of course, also poses some challenges for management, and limiting the power of large shareholders through the voting schemes referenced above is advisable only for corporations with well structured divisions of power and for which survival does not depend on rapid, consensual decision making. These are lessons that apply to a subset of corporations in Brazil and other countries of the world.

Table 1.3 summarizes the main differences between the law and finance approach and that suggested by the current book. The main differences are

[37] See Tarun Khanna and Krishna Palepu, "Globalization and Convergence in Corporate Governance: Evidence from Infosys and the Indian Software Industry," *Journal of International Business Studies* 35, 6 (November 2004): 484–507, esp. pp. 489–490.

[38] Paul Healy and Krishna Palepu, "Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature," *Journal of Accounting and Economics* 31 (2001): 420.

Table 1.3. *Main differences between the law and finance and corporate and finance approaches*

Main components	Law and finance	Corporate practice and finance
Role of company and bankruptcy laws	Central role, providing shareholder and creditor rights at the national level as well as mandating disclosure of accounts and detailed information of the activities of founders and directors. Should provide bright line rules that can facilitate enforcement by judges	Should provide a basic framework to facilitate enforcement, disclosure, and criminal trials for fraudulent practices
Role of company by laws	Do not have to provide additional protections beyond those in national laws. If they are too complex it is hard for courts to enforce investor protections	Can substitute for shortcomings of the law
Disclosure of financial information and information at the time of initial public offering of stocks (and bonds)	Central to facilitate the private enforcement of shareholder (and creditor) rights	Central to facilitate the private enforcement of shareholder (and creditor) rights
Disclosure of shareholders	Only necessary at the time of initial public offering and only if shareholders have a large stake or an interest in the offer of new securities	Regular disclosure of shareholders' identities can facilitate private monitoring of insider power
Causal mechanism	Legal traditions were inherited or adopted hundreds of years (or decades) ago and generated distinct legal systems and investor protection schemes across countries	Investor protections are determined mainly at the company level by shareholders. Creditor rights and mandatory disclosure of information regulated at the national level are determined by political interactions between interest groups and legislators
Role of history (and historical research)	Strong path-dependence. The fate of countries regarding investor protections was determined when they adopted or inherited their legal systems	The institutions of corporate governance are contingent to what companies do. That is why historical research plays a critical role in understanding the transformation of investor protections overtime

in the roles given to national company and bankruptcy laws, the causal mechanism behind investor protections, and, in general, the role of historical research. While for the law and finance approach national laws are central, I argue that while some national laws are important, especially those that mandate disclosure of financial and company information relevant to shareholders, company bylaws can substitute for some of the laws that supposedly should provide the protections that shareholders need to be encouraged to buy equity with confidence. Finally, I argue that the investor protections are not a consequence of the legal tradition countries follow, but rather are selected by shareholders or the founders of new companies when they draft the company statutes or, when included in national laws, protections are determined by the interaction of interest groups and politicians. I develop most of these arguments using the case of Brazil and, when possible, displaying comparative evidence from a variety of countries.

STRUCTURE OF THE BOOK

The second chapter presents evidence of the development of sizable stock and bond markets in Brazil between 1882 and 1915 and explains why the country's financial markets grew rapidly after 1882. By some measures Brazil's bond market was more developed in the past than today. Chapter 3 demonstrates that financial development mattered for Brazilian economic development by documenting the important role the stock markets played in the country's industrialization and urbanization. It finds significant statistical links that suggest possible causality between levels of bank credit and stock and bond issues and movements in the country's gross domestic product. Detailed data on the capitalization of the Rio de Janeiro and São Paulo stock exchanges are used to show the extent to which stock markets were used to finance the expansion of companies in all sectors of the economy. The stock markets provided capital to finance industrialization at the time when the country's GDP growth accelerated and helped to transform Brazil into a more urbanized and industrialized country by mobilizing resources for new sectors such as manufacturing and utilities, railways, banks, insurance companies, and others.

Chapter 4 examines the institutional settings that enabled corporations to induce large numbers of small investors to purchase equity. It looks at how, in the absence of regulation at the national level, Brazilian corporations interested in attracting outside investors devised statutes within their bylaws that protected small investors against the power of large shareholders who could otherwise control the company to their advantage.

The assertions made in Chapter 4 regarding the effects of voting provisions and government guarantees are empirically tested in Chapter 5, which finds that concentration of ownership (shareholdings) and control (votes) was significantly lower both in companies that had voting provisions that limited the power of large shareholders and in companies closely monitored because they had government-guaranteed dividends. Thus, in Brazil, investor protections incorporated in company bylaws seem actually to have worked in practice.

Chapter 6 continues to examine the importance of corporate bylaws, with particular emphasis on the structure of the rules and incentives that regulate directors in Brazilian corporations. Two points are made. First, corporate charters provided investors with detailed information about executive compensation including directors' fixed salaries and performance-based fees. In many instances, full compensation was determined by the shareholders at the general assembly. Second, using information from corporate charters to estimate the compensation of the presidents of the boards of directors of many of Brazil's largest corporations circa 1909 (who also acted as chief executive officers), this chapter compares average salaries (by size of the corporation) in Brazil to those in the United Kingdom and the United States (the results are hard to interpret because it is not clear that the comparison is fair). The pay of Brazilian CEOs was equivalent to directors of medium-sized companies in the United Kingdom and perhaps to directors of small to average companies in the United States. Even if Brazilian CEOs salaries were higher than those of the United States, it is not clear whether higher salaries were truly a sign of weak corporate governance or just a symptom of the scarcity of talent in this economy.

Chapter 7 examines the development of bond markets in Brazil and the institutional conditions that protected bondholders. The institutional setting for bond markets differed from that for stock markets because Brazilian bankruptcy laws provided strong protections for creditors since at least 1850. From the first commercial code, Brazilian legislation gave creditors control of corporate bankruptcies, allowed them to select trustees to run bankrupt companies, and granted them discretion to choose whether to liquidate or to negotiate a plan with incumbent management to reorganize a firm. Secured creditors (those with collateral) were always first in line to collect debts during bankruptcy, and after 1890 bondholders were accorded the status of privileged creditors. With this legislation as a backdrop, Brazilian bond market activity first peaked before 1915 while helping to finance the activities of companies in almost all of the most important industries of that time. Just as in the stock markets, the acceleration of bond financing occurred after 1900, in particular between 1906 and 1913 when coffee exports were booming because of the coffee valorization program and macroeconomic conditions were stable thanks, in part, to the institution of the gold exchange standard.

Chapter 7 also demonstrates that creditor rights were not only protected on paper, but also strongly enforced by the courts. I draw on archival records of bankruptcy cases of corporations that issued bonds to show that bondholders were, indeed, in a privileged position when bankruptcies occurred, commonly negotiating reorganizations and sometimes liquidating assets to recover their investments. If perhaps less than perfect, the process was usually brief (especially compared to today's time-consuming bankruptcy procedures). I reach conclusions: (1) the enforcement of creditor rights was strong between 1850 and the first decades of the twentieth century (i.e., strong creditor protections have been the norm for a good part of Brazil's history), (2) bankruptcy judges enforced creditor rights not only because that was their mandate, but also because they, too, were investors in the stock and bond markets, and (3) this equilibrium changed after the 1930s with the advent of a corporatist regime interested in protecting labor rights that radically changed the protection and enforcement of creditor rights.

The findings presented in Chapter 8 suggest that in Brazil the development of stock and bond markets does not seem to be explained by the dealings of banks acting as market makers. At the end of the nineteenth century, many countries achieved significant levels of financial development without necessarily providing strong protections for investors, whether in company laws, bankruptcy laws, or corporate bylaws. According to a large literature that explores the role of large investment and universal banks in countries such as the United States and Germany, the actions of banks as underwriters, promoters, and guarantors of corporate securities substituted for some of the protections investors otherwise would have expected from the legal system or from corporations themselves. Chapter 8 falsifies the hypothesis that banks were acting as market makers and intermediating between companies and investors in Brazil by pointing out that in countries in which banks played the role of market makers bankers usually sat on the boards of directors of many corporations and ended up being central actors in the network of corporate interlocks (the web of relations among corporations established through their boards of directors). I employ network analysis to show that Brazilian banks were not central actors in these networks and did not have as many interlocking boards with corporations in other industries as was commonly the case in economies that relied on bankers to play the role of market maker (e.g., Germany, Mexico, and the United States).

Taken as a whole, the first eight chapters argue that financial markets grew, in part, because of a system of investor protections that worked between 1882 and World War I. After that, evidence of financial market size shows stock and bond markets to have declined rapidly in the wake of WWI. Chapter 9 explains why financial markets in Brazil declined after 1915 by testing some of the hypotheses advanced in the literature to explain the "great reversal" in financial development worldwide in the 1920s and 1930s. The initial decline in stock and bond market activity in Brazil after 1915 coincides with diminished international capital flows consequent to the controls and instability associated with WWI. But even after international conditions improved after WWI, financial markets in Brazil did not recover because its higher inflation rates kept investors' returns negative in real terms. As support for financial markets faded away in the 1930s and 1940s, the most powerful interest groups of industrialists and labor had reached consensus around promoting a new corporate model less concerned with protecting outside investors and focused instead on preserving employment and consolidating domestic industry.

Chapter 10 shows how the system of corporate governance and finance evolved after the 1930s. It shows how the concentration of ownership increased after congress introduced preferred shares in the 1930s and as a consequence of the rise of government ownership in strategic sectors. The chapter also shows how changes in corporate governance led to change in corporate finance as well. In particular, Brazilian companies shifted their financial structure from more reliance on stocks and bonds to a system that relied more heavily on bank credit.

Chapter 11 concludes by presenting the main lessons of the book for companies and policy makers and discussing the conditions that could lead us to another great reversal in financial development, accompanied by radical changes in corporate governance.