

Law and Finance: Would Improved Investor Protection help the ECMU ?



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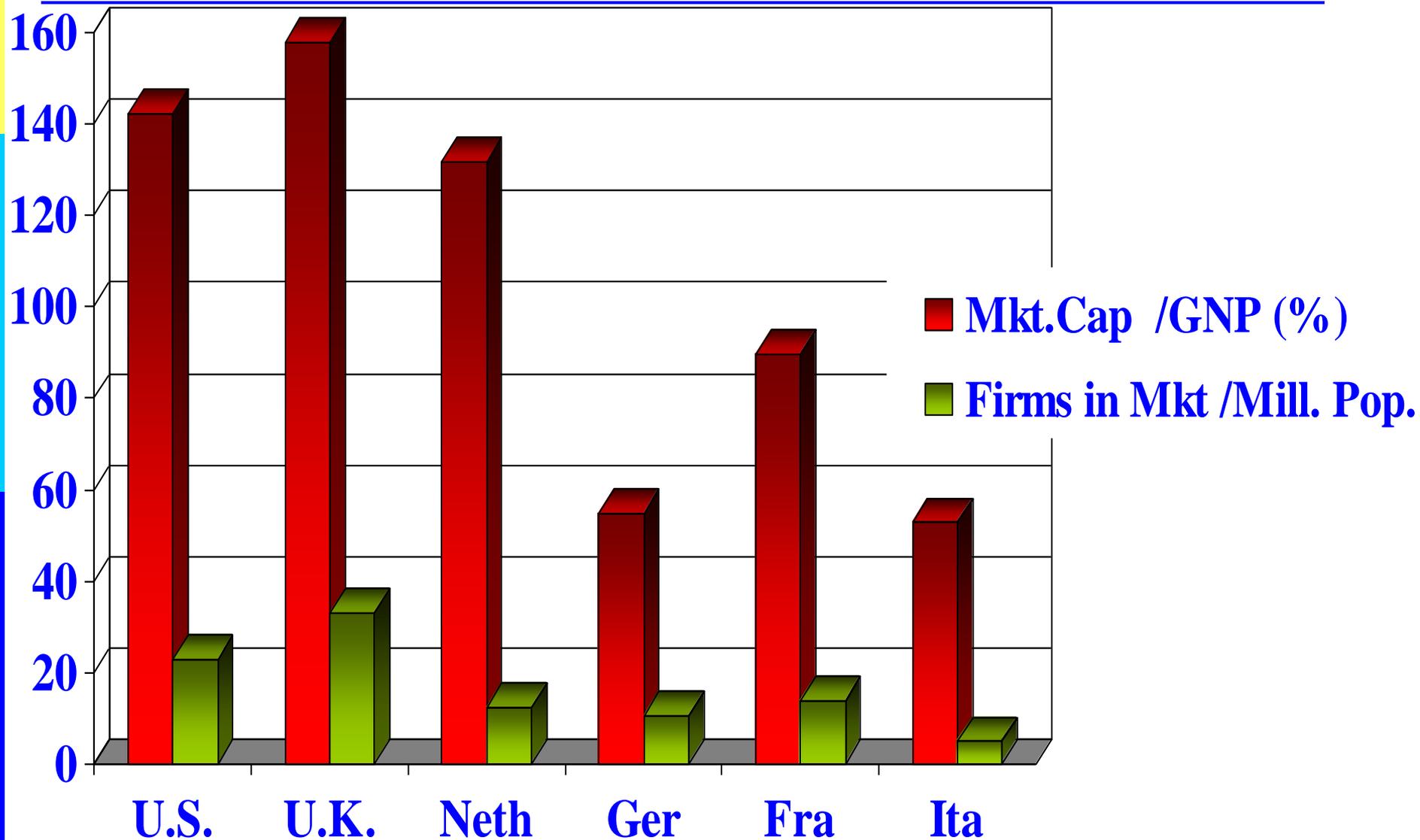
EDHEC Business School

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Why do some Developed Countries have broader and more valuable capital markets?



Do Investors need Protection?

The Law and Finance Approach

- ✓ Firms need capital to invest, but access to low cost funds is difficult if investors (shareholders and creditors) fear that firm insiders may expropriate their funds.
 - ✓ → *fundamental moral hazard / corporate governance problem*
- ✓ Main goal of investor protection is to restrict expropriation to facilitate external finance.
- ✓ The **law** and its **enforcement** are key mechanisms of investor protection: When investors finance firms, they receive rights or powers in exchange. Without an ability to enforce rights, investors might end up with nothing.
- ✓ All non-controlling investors (outsiders) need their rights protected: dispersed minority shareholders; significant but non-controlling shareholders; small creditors; banks

A diagram consisting of two light blue rectangular boxes with black borders. The left box contains a list of legal and regulatory mechanisms, and a large blue arrow points from this box to the right box. The right box contains two bullet points representing the goals of investor protection.

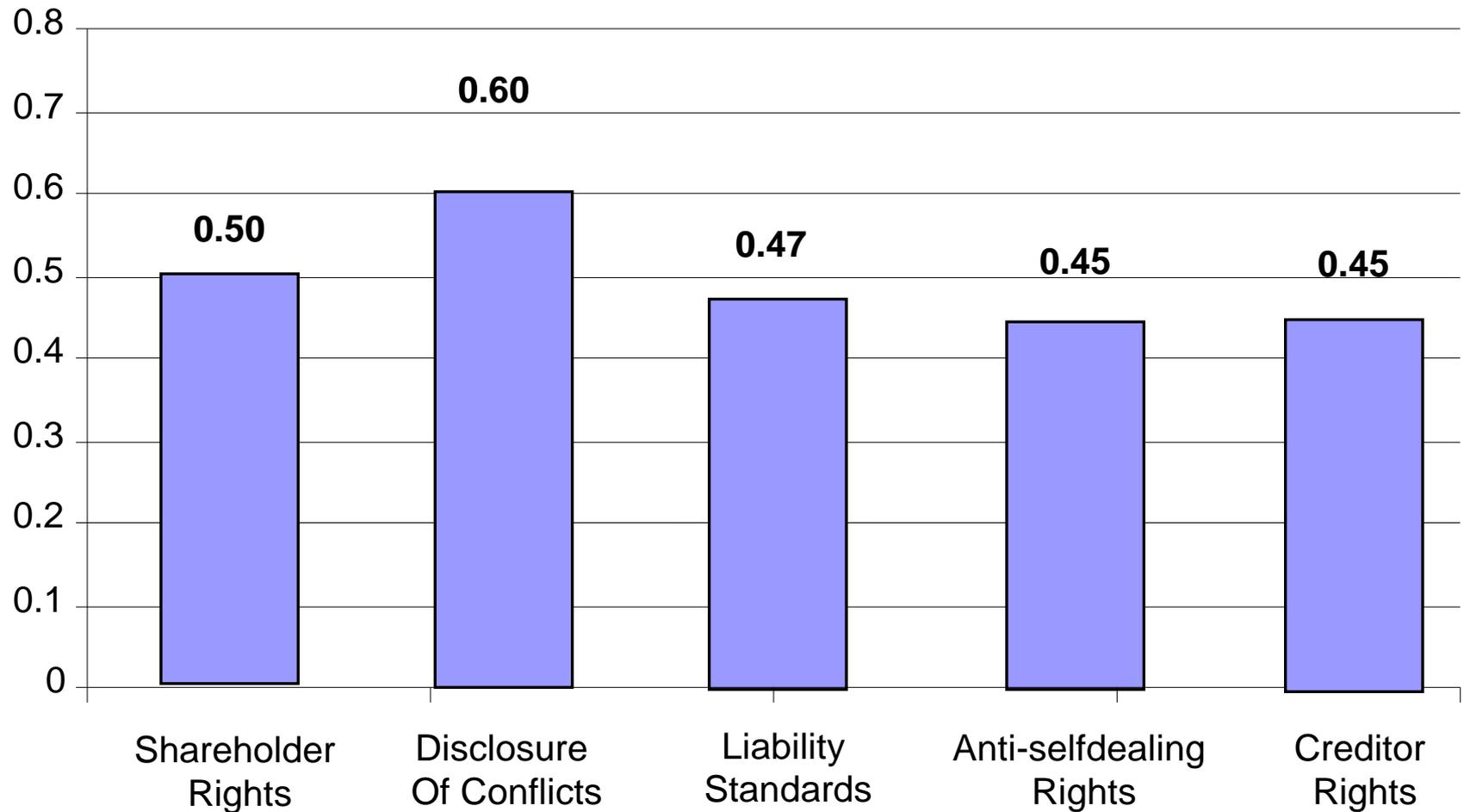
- **Corporate law**
- **Securities law**
- **Liability Standards**
- **Bankruptcy law**
- **Courts & Regulators**

- **Protect Shareholders & Creditors**
- **Force timely disclosure of accurate information**

- ✓₃ **Implication: Strong investor protection leads to deeper financial markets & better financing terms for firms.**

Investor Protection Measures

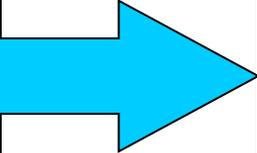
World Means



Outcomes

- ✓ Investor protection should be associated with a higher number of listed firms and higher valuation of capital and, lower private benefits, ownership concentration and earnings manipulations, as well as larger private credit and bond markets:

**•Good laws &
•Efficient
Enforcement**



↑ Stock Market Capitalization / GDP
↑ Access to Equity
↑ Number of IPOs and Listed Firms
↓ Ownership Concentration
↓ Private Benefits of Control
↓ Earnings Manipulation
↑ Private Credit
↓ Interest Rate Spreads

Disclosure of Conflicts of Interest, Liability Standards and Market Capitalization



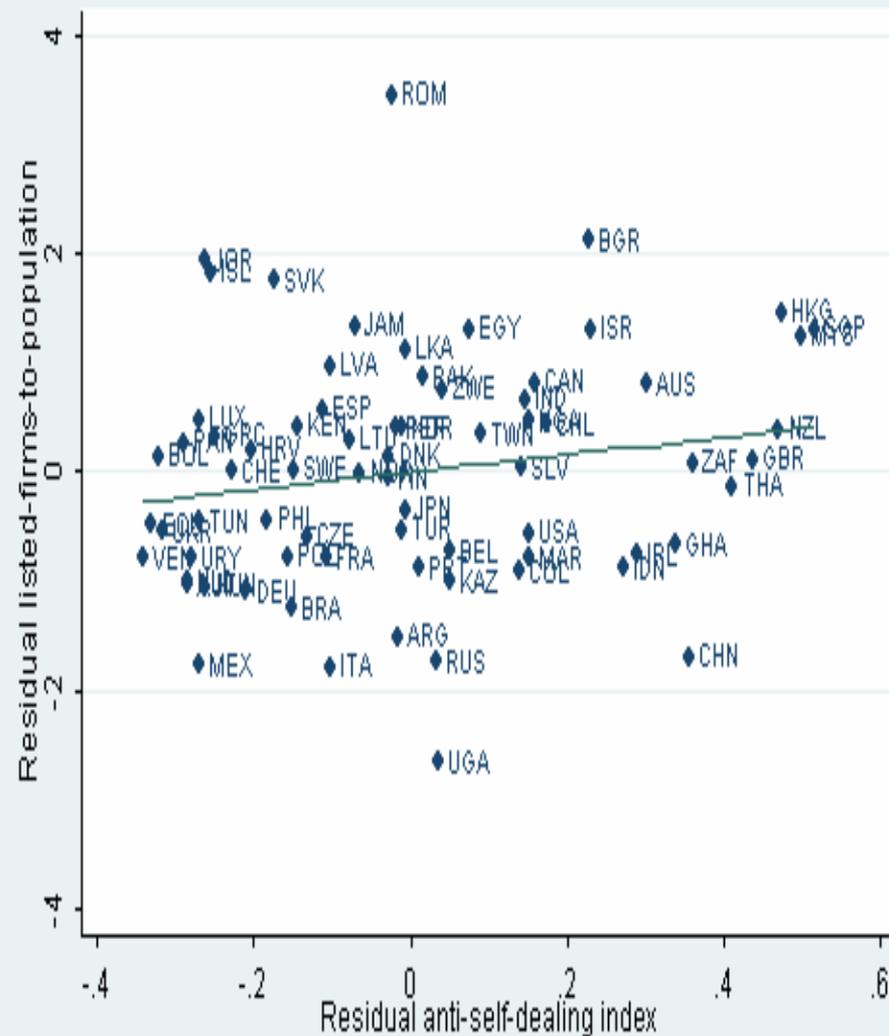
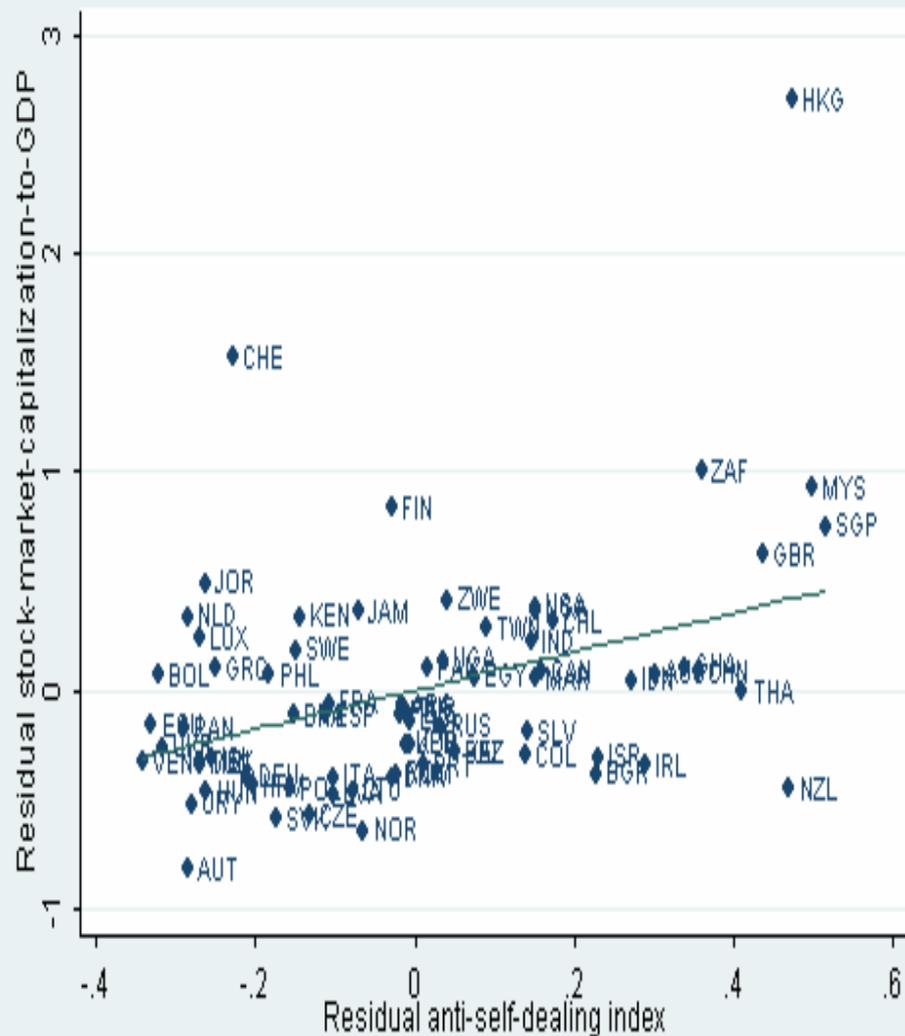
coef = .7818512, (robust) se = .14132285, t = 5.53



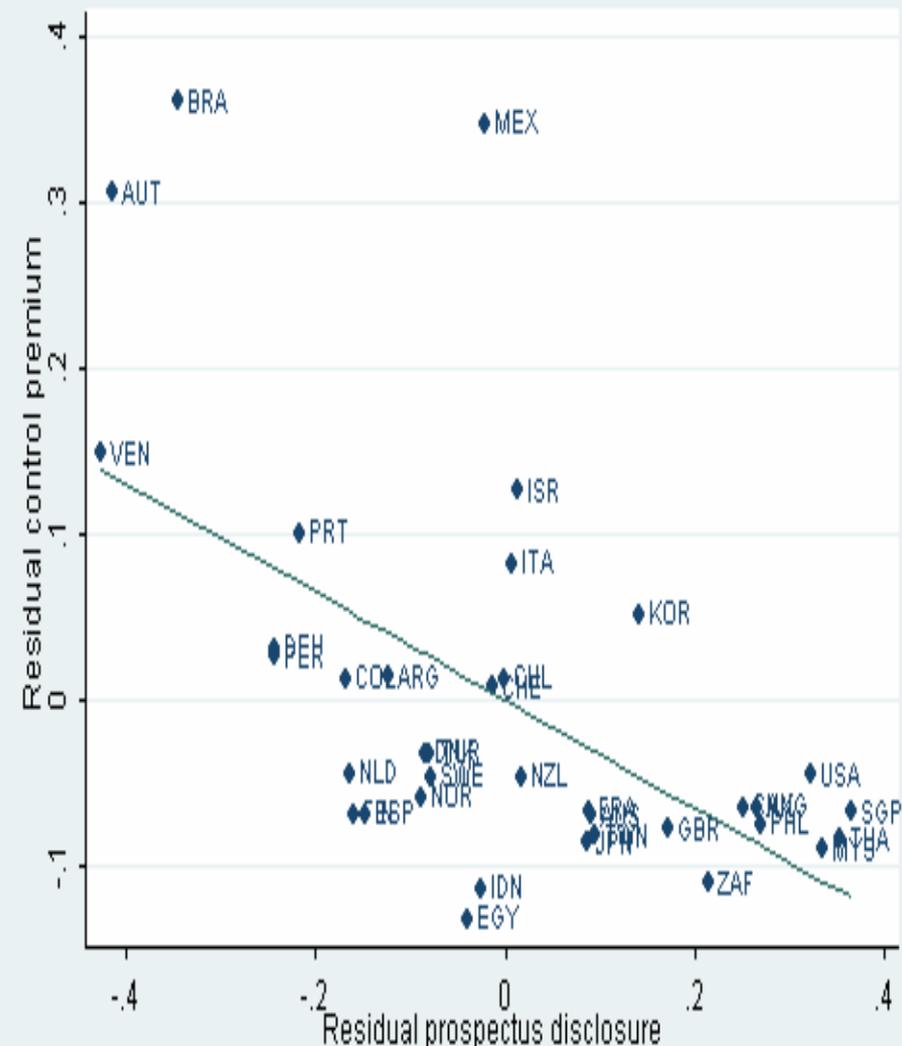
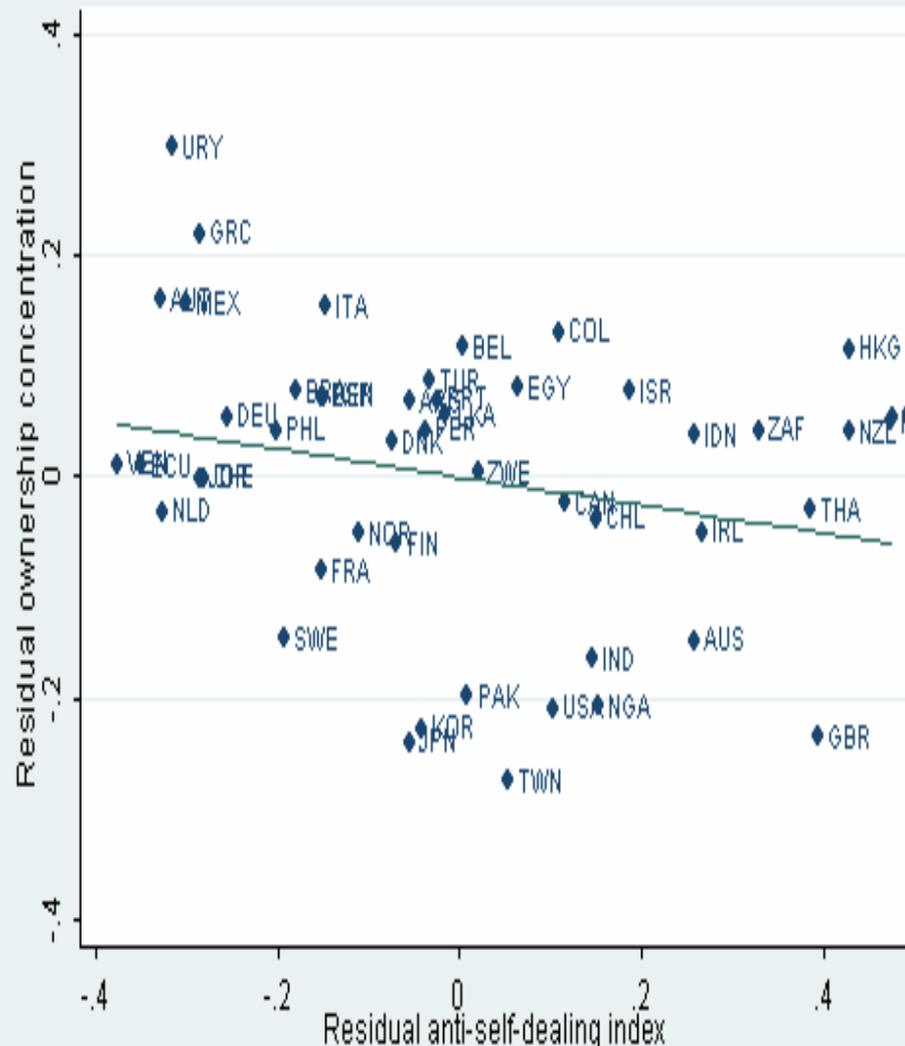
coef = .64485842, (robust) se = .12922437, t = 4.99

Anti-Selfdealing Rights

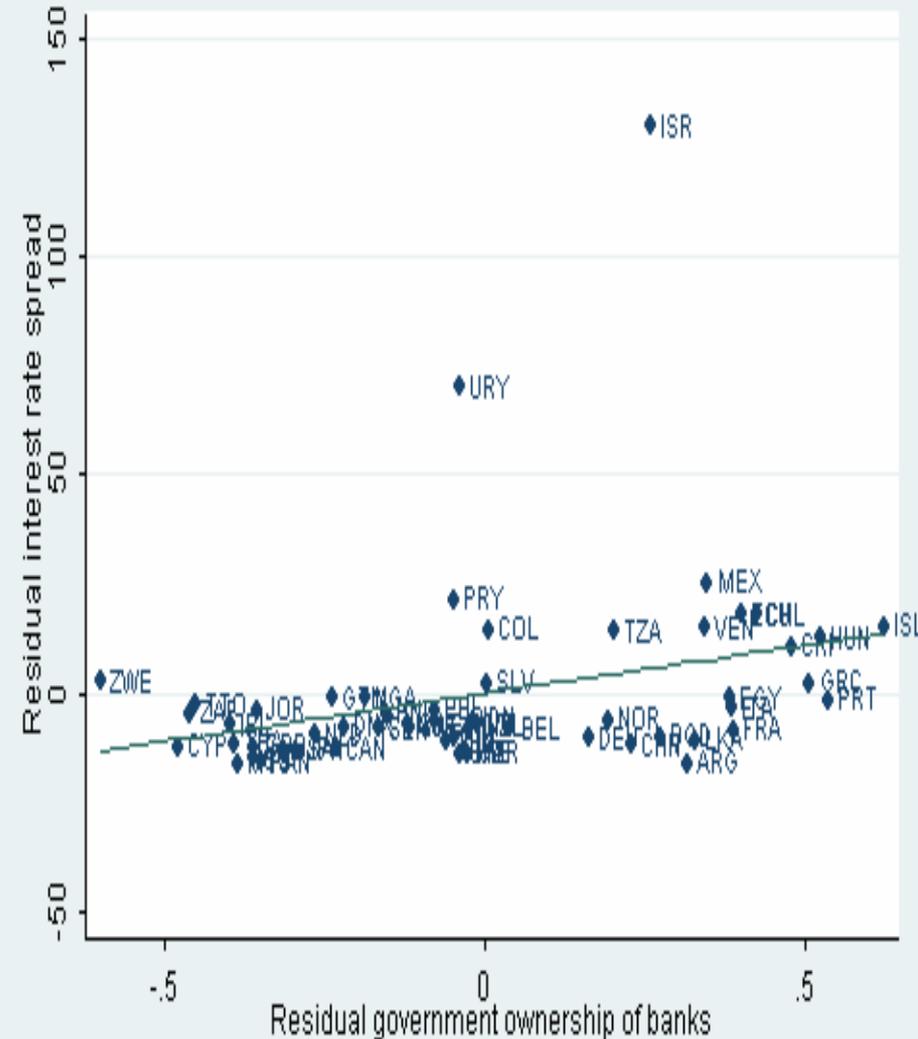
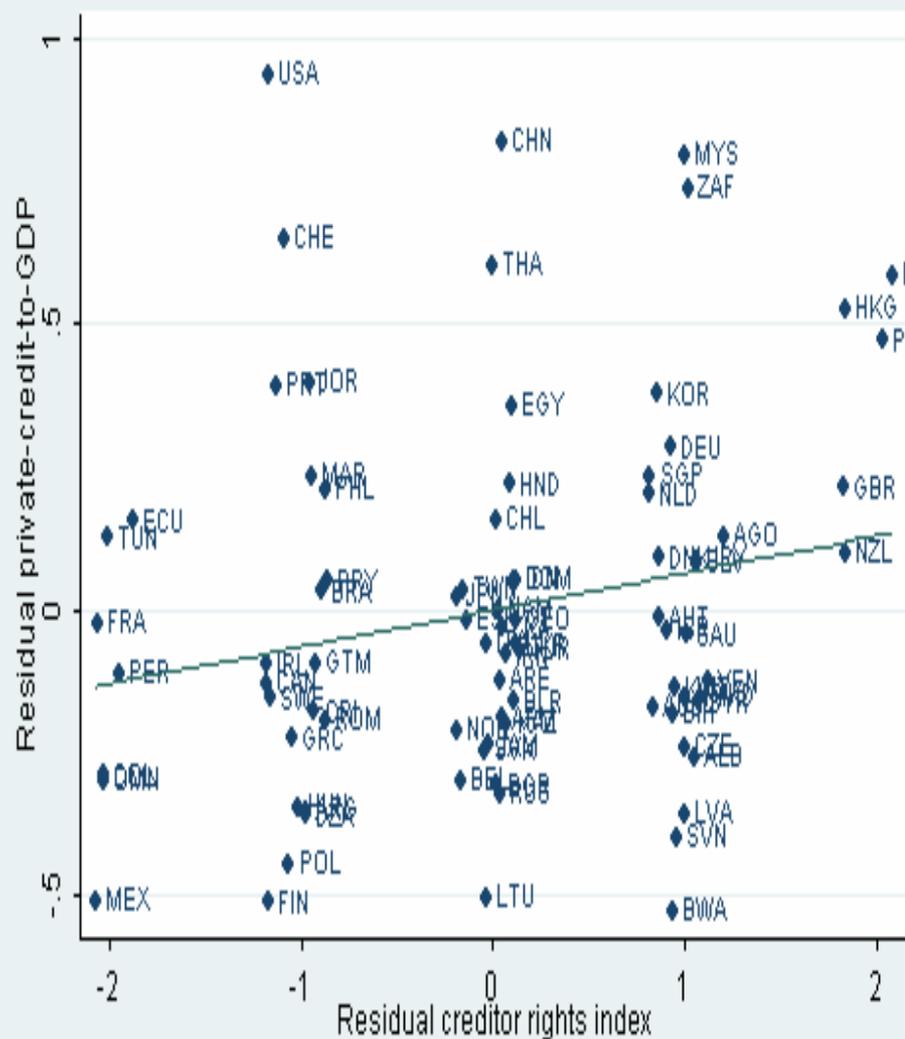
Market Capitalization and Number of Listed Firms



Financial Investor Protection, Ownership Concentration and Control Premium

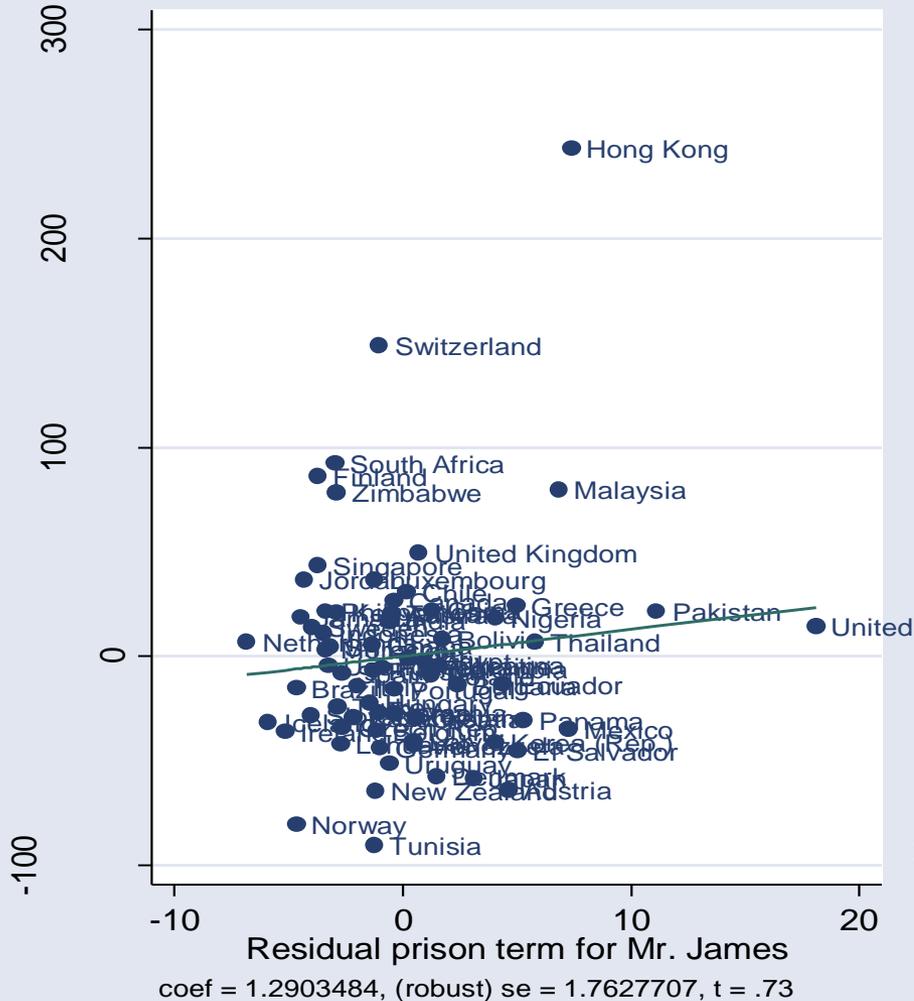


Creditor Rights and Private Credit and Interest Rate Spreads

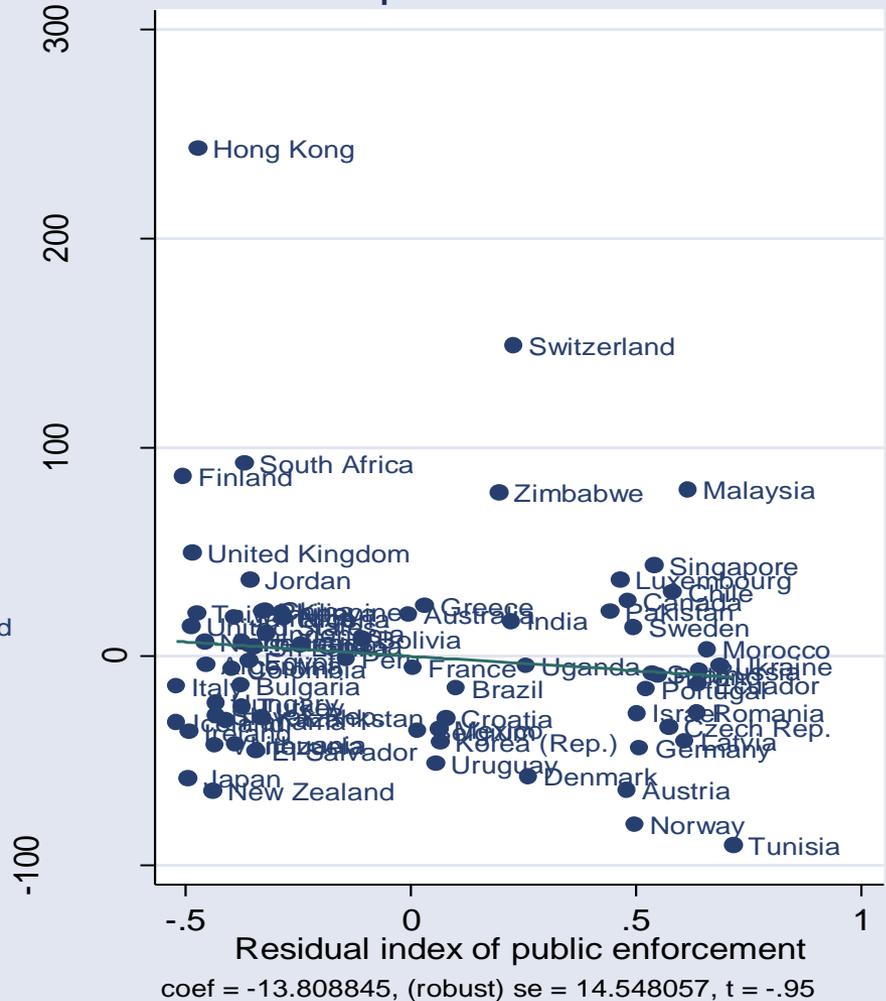


Public Enforcement and Capital Markets Development

The transaction is not disclosed



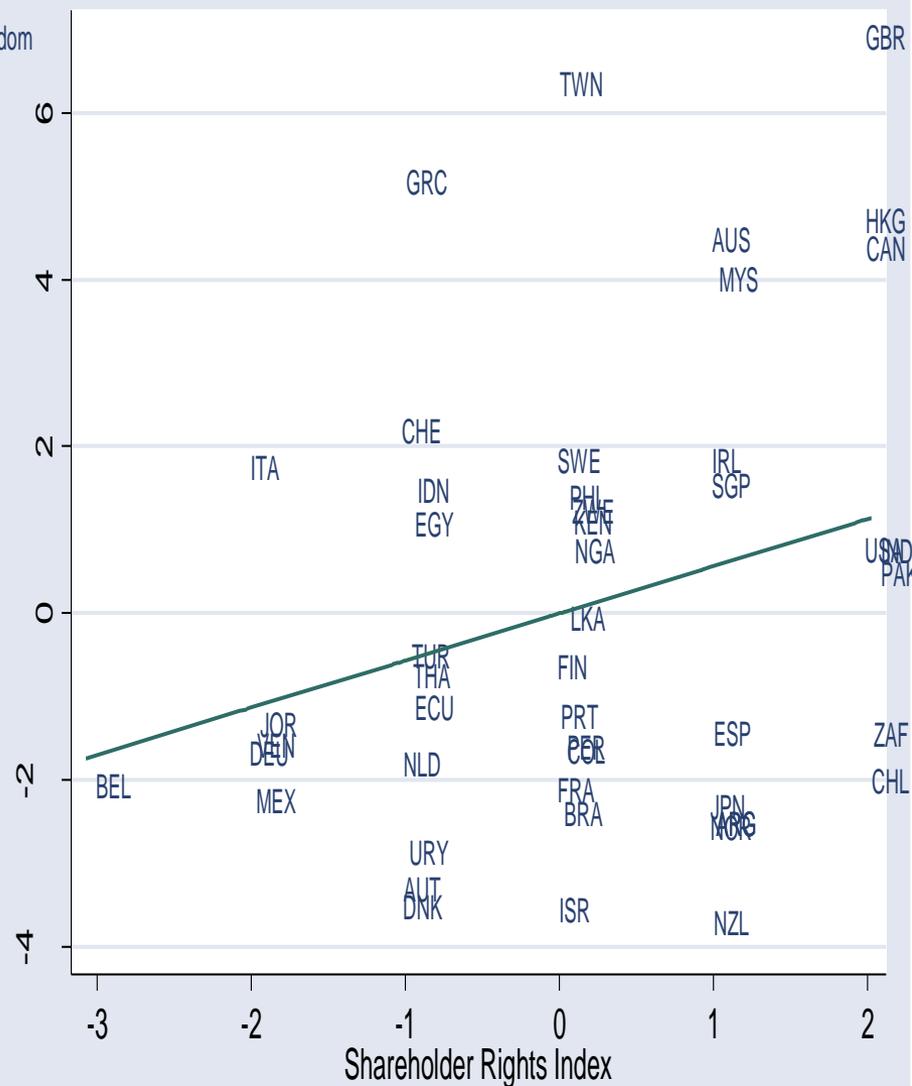
All requirements are met



Investor Protection and IPO value



coef = 4.1412864, (robust) se = 1.7922779, t = 2.31

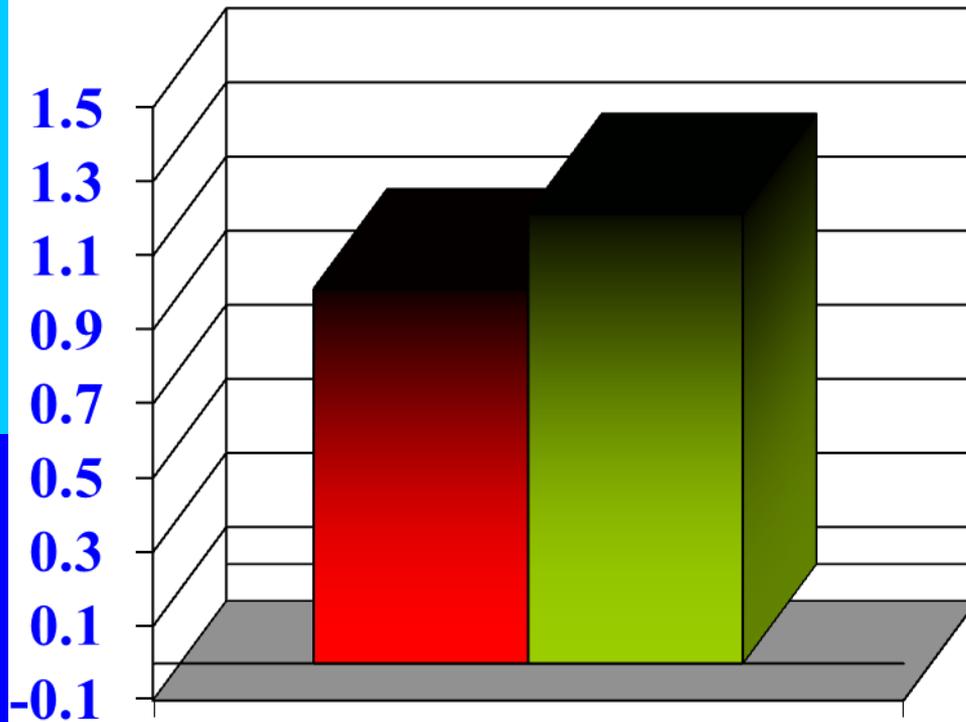


coef = .56476115, (robust) se = .27698973, t = 2.04

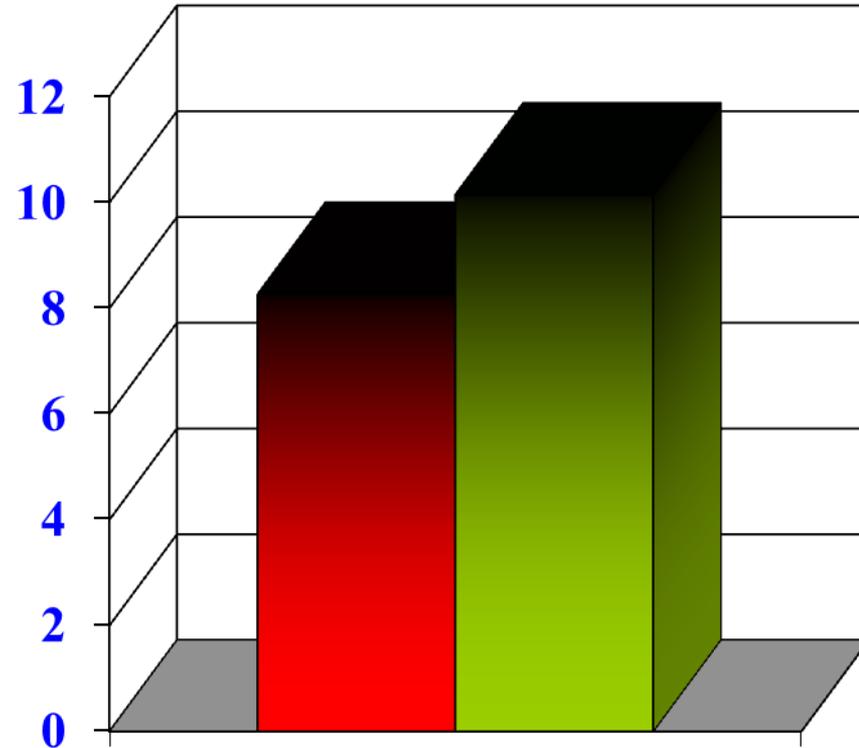
Investor Protection and Firm Valuation

■ Low Shareholder Rights

■ High Shareholder Rights



Tobins' Q (MV/BV)



Price/CashFlow

Implications for the Capital Markets Union

- Taken at face value, this work has implications for the current financial crisis:
 1. The Public sector has a role to play as designer of the rules:
 - Countries with successful stock markets give shareholders the information they need and the power to act – including both voting and litigation -- on this information.
 - No evidence that successful countries rely heavily on fines and criminal sanctions (LLS, 2006).or heavy public intervention (LLS, 2008)
 2. Specific Recommendations for corporate Governance policy reform:
 - Combine full disclosure of self-dealing transactions with the requirement of approval by disinterested shareholders – inexpensive and straightforward to implement.
 - Need to set a lower bound, particularly because of concentrated ownership
 - But, no real reason for it not to work in rich or poor or civil law countries
 - Combine on-going disclosure of self-dealing transactions with a relatively easy burden of litigation placed on the shareholders, also benefits stock market development – more difficult to implement.
 - Success may depend on general structure and efficiency of legal systems

Implications for the Capital Markets Union

3. Connection with the Financial Crisis

- Lack of appropriate disclosures were part of the problem
- Components of the solutions should include:
 - Disclosure of derivatives, leverage, on & off balance sheet
 - Emphasis on disclosure to the public not just the Central Banks
 - Improvement in bankruptcy of financial institutions
 - Regulation of leverage: source of externalities
 - Private ownership of banks & No limitations on financial innovation

4. There are disadvantages of more restrictive regulation

- Politicization of banking with probably adverse effects on growth and credit availability
- Undermining of innovation

An alternative view



An Alternative view

It ain't over

1

Number of rule-making requirements for Dodd-Frank
Selected categories, as of February 14th 2012



Source: Davis Polk

Caught in the web

2

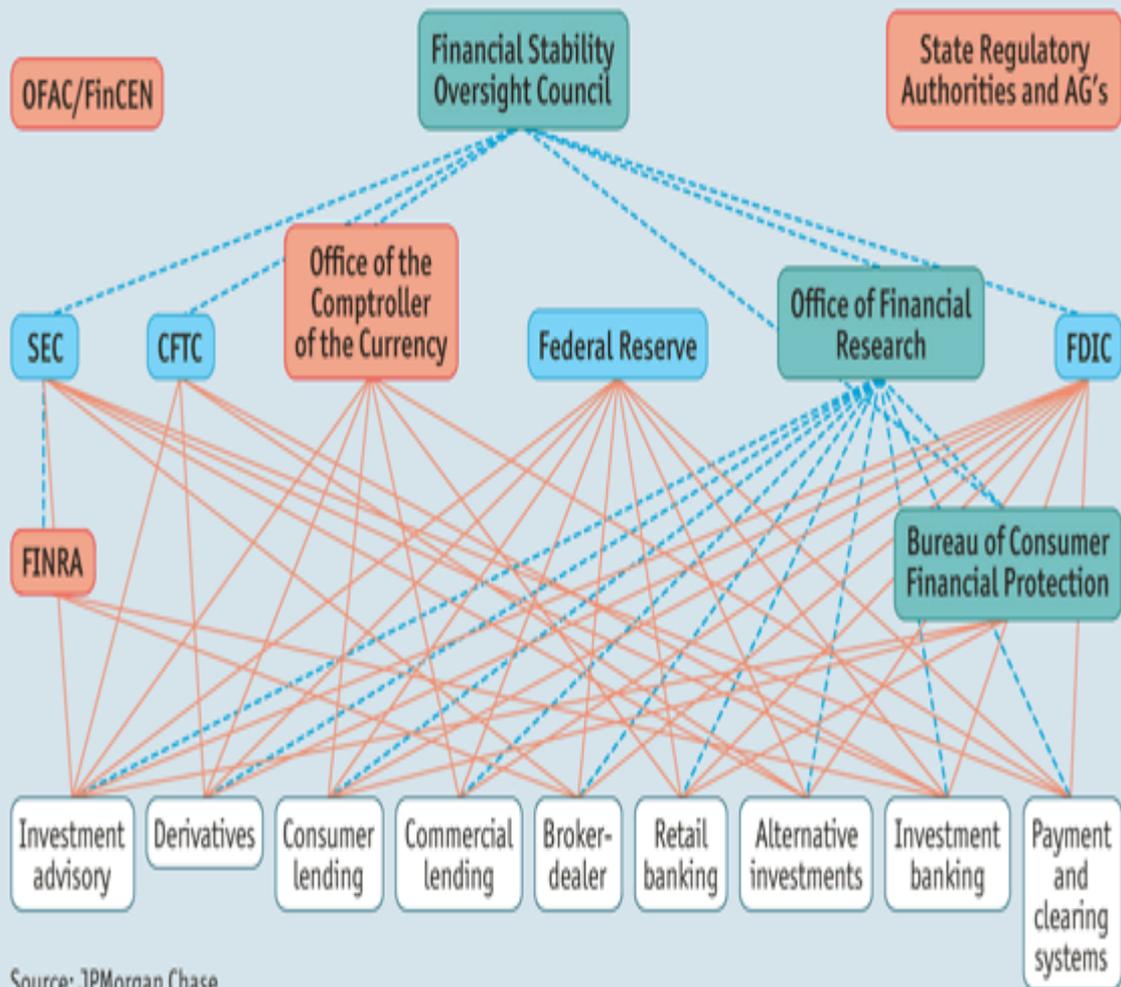
Who can do what to whom

Financial agencies:

Old (orange) New (teal) Old with new powers (light blue) Affected parties (white)

Lines of reporting:

Can request information (dashed blue) Has authority to examine (solid orange)



Source: JPMorgan Chase

Conclusion

- ✓ Empirically, strong investor protection is associated with more effective corporate governance as reflected in valuable and broad financial markets
- ✓ In many countries, Developed Economies or Emerging Markets, companies need access to capital, but have room to engage in self-dealing may leave investors with an empty shell.
- ✓ Market mechanisms alone do not solve these problems because:
 - ✓ Market participants, such as financial intermediaries and analysts, may have the wrong incentives; and
 - ✓ Arbitrage may not bring prices of volatile securities with uncertain fundamentals close to their fundamental values.
- ✓ A component of the CMU should be foster better investor protections so as to reduce the cost of capital across countries.

Appendix



Investor Protection Measures

Creditor Rights:

A score of one is added for each of the following legal rights of secured lenders: (1) there are restrictions, such as creditor consent, for a debtor to file for reorganization; (2), there is no “automatic stay” on assets; (3) secured creditors are paid first out of the proceeds of liquidating a bankrupt firm; (4) management does not retain administration of property pending the resolution of the reorganization. The final score is divided by the number of components of the index.

Shareholder Rights:

The index is formed by adding 1 when: (1) the country allows shareholders to mail their proxy vote to the firm; (2) shareholders are not required to deposit their shares prior to the General Shareholders’ Meeting; (3) cumulative voting or proportional representation of minorities in the board of directors is allowed; (4) an oppressed minorities mechanism is in place; (5) the minimum percentage of share capital that entitles a shareholder to call for an Extraordinary Shareholders’ Meeting is less than or equal to 10 percent (the sample median); or (6) shareholders have preemptive rights that can only be waived by a shareholders’ vote. The final score is divided by the number of components of the index.

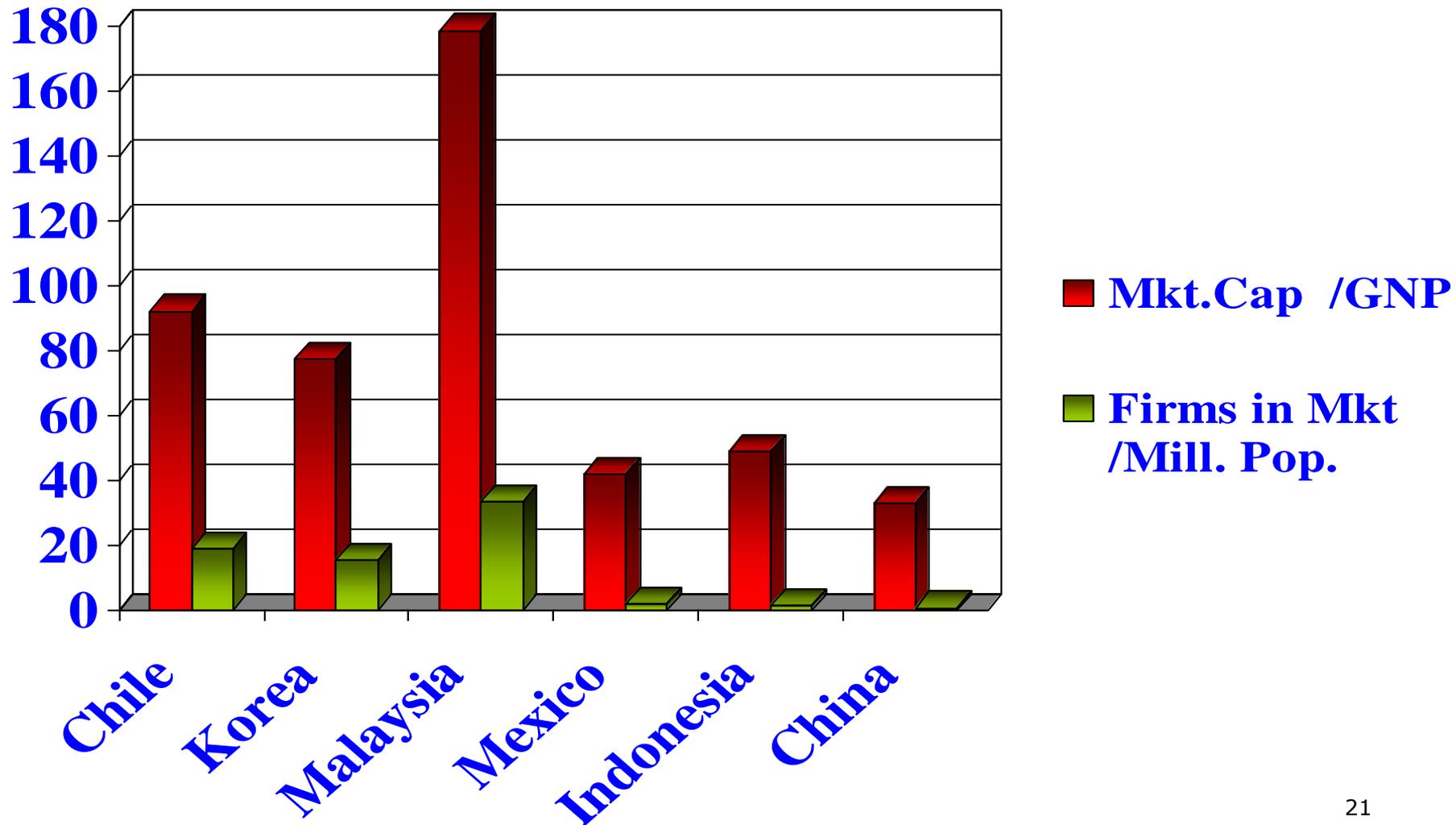
Disclosure of Conflicts of Interest:

The index equals the arithmetic mean of: (1) Prospectus; (2) Compensation; (3) Shareholders; (4) Inside ownership; (5) Irregular contracts; (6) and Transactions. Each of the measures is standardized to be between zero and one.

Liability Standards:

The index equals the arithmetic mean of: (1) Liability standard for the issuer and its directors; (2) Liability standard for the distributor; and (3) Liability standard for the accountant. Each of the measures is standardize to be between zero and one.

Why do some Emerging Markets have broader and more valuable capital markets?

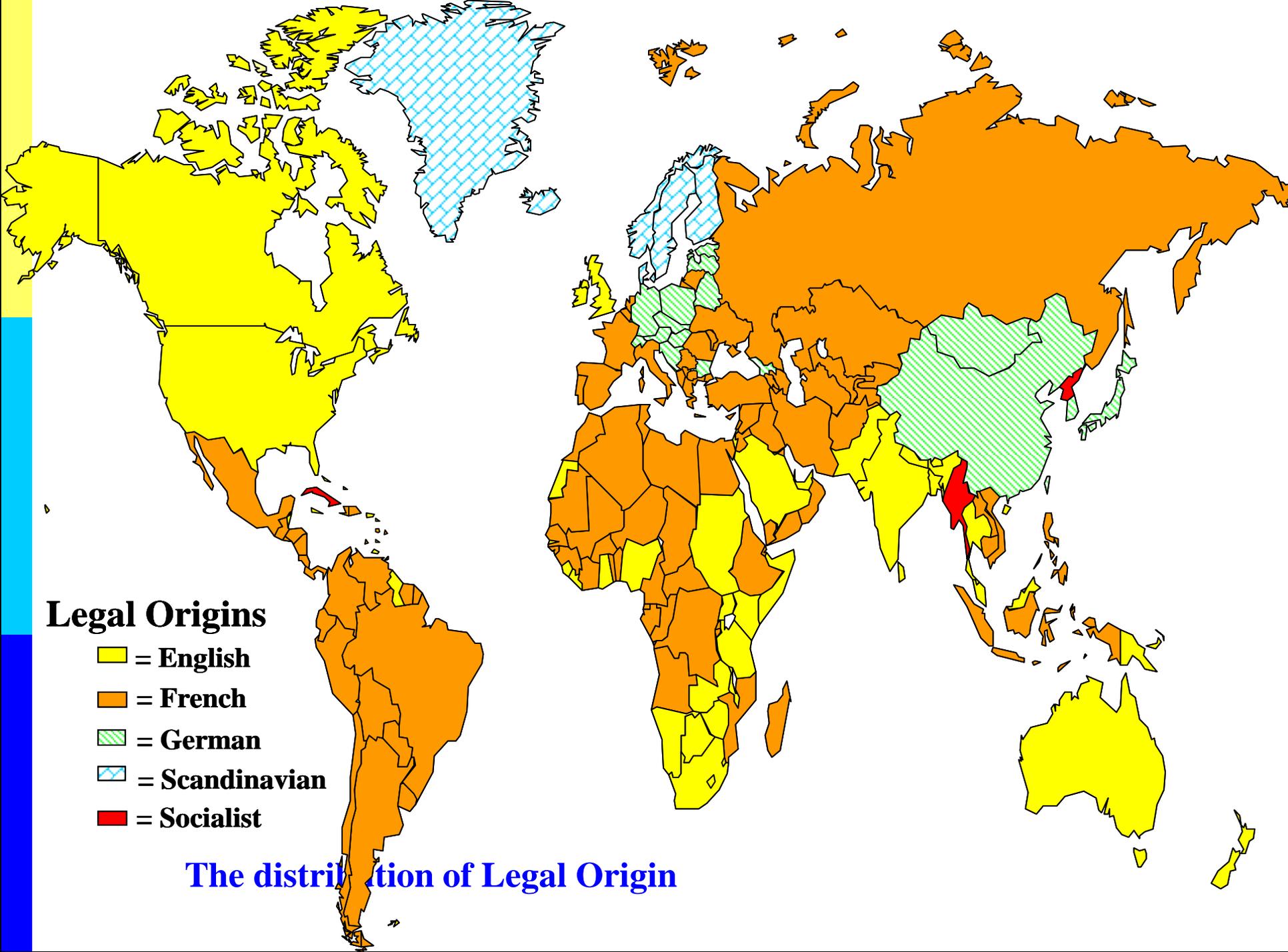


Appropriate Institutions

- ✓ Economic developments of the late 20th c and early 21st c have increased interdependence and provided great stimulus to research in institutional and comparative economics
- ✓ European integration and NAFTA, Transition from socialism, and various world crises (Asian, Russia, Tequila, US-Mortgages) have raised many questions about which institutions work and how they work.
- ✓ There is a variety of capitalist institutions which may lead to different results in a more interdependent world.
- ✓ Although the goal of good institutions -- economic and political -- is to secure liberty and property rights, it is clear that countries have different institutions to meet these goals. Thus the question of appropriate institutions.

Efficient vs Inefficient Institutions

- ✓ Efficient institutions minimize the sum of the costs of disorder and dictatorship.
- ✓ However, the institutions that we observe are likely to be inefficient. There are two prominent sources of inefficiency:
 - 1. Politics:** because most governments in the world are far from perfect, so are the institutions they design and perpetrate.
 - ☞ Tendency towards excessive regulation.
 - 2. Colonial transplantation:** many institutions in developing countries are not indigenous, but rather were transplanted during colonization.
 - Although many transplanted institutions improve the security of property rights, there is no reason to think that colonial transplantation is automatically efficient.



Legal Origins

- Yellow = English
- Orange = French
- Green with diagonal lines = German
- Light blue with grid pattern = Scandinavian
- Red = Socialist

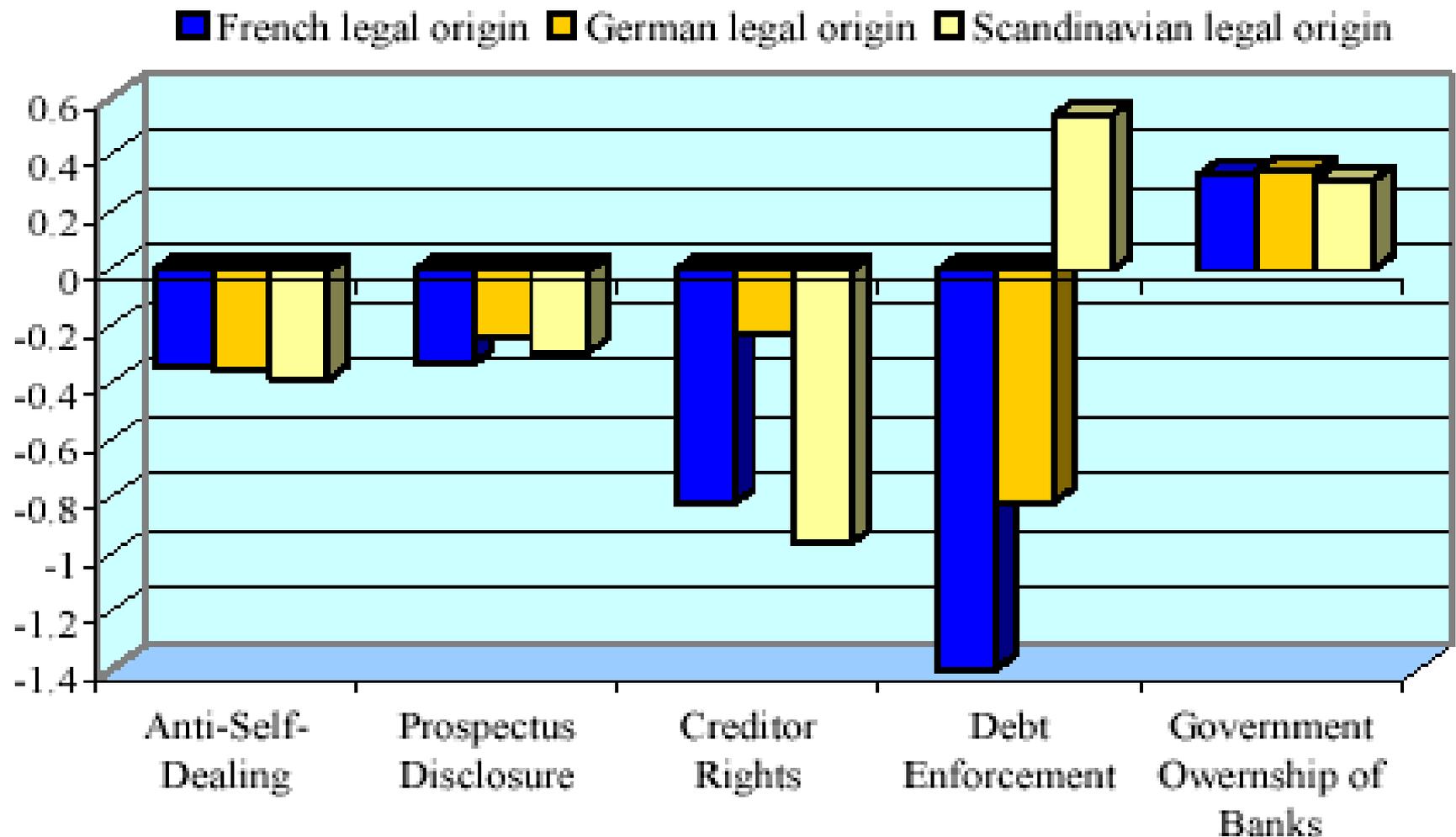
The distribution of Legal Origin

The Measurement of Institutions in the past 15 years

- 1) **Legal rules** of investor protection **can be measured** and coded across countries using national commercial (primarily corporate and bankruptcy) laws.
 - Coding showed some countries offer stronger investor protections than others.
- 2) **Legal rules** protecting investors **vary systematically among legal traditions** (LOs):
 - Laws of common law countries are more protective of outside investors than the laws of civil law, and particularly French civil law countries.
 - Countries with more protective laws have more developed capital markets
- 3) **Civil law shows a heavier hand of government** ownership and regulation
 - LO predicts government ownership of banks, burden of entry regulations, regulations of labor markets, incidence of military conscription, and government media ownership.
 - These indicators are associated with adverse impacts on markets, such as greater corruption, larger unofficial economy, and higher unemployment.
 - Common law is associated with lower formalism of judicial procedures and greater judicial independence than civil law.
 - These indicators are associated with better contract enforcement and greater security of property rights.

Financial Institutions and Legal Origins

The values represent the average difference of the countries within each legal origin relative to the countries of the common law legal family. The values are the coefficient of each legal origin dummy in a regression that also controls for the Log of GDP per capita and a constant.

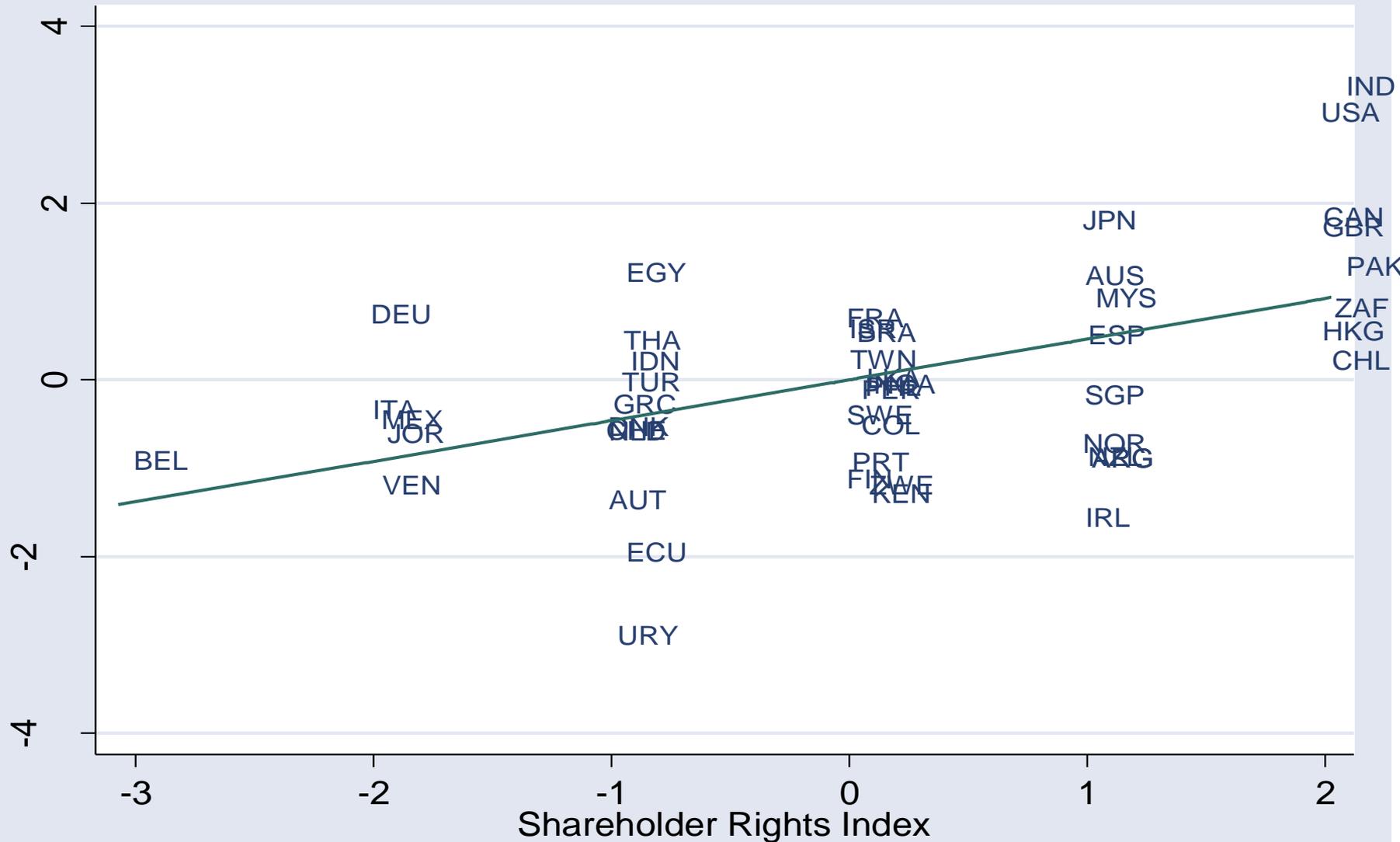


Note: The values of the coefficients for the columns of Debt enforcement have been divided by 10 to improve the scale of the graph.

Fundamental Problem of Corporate Governance

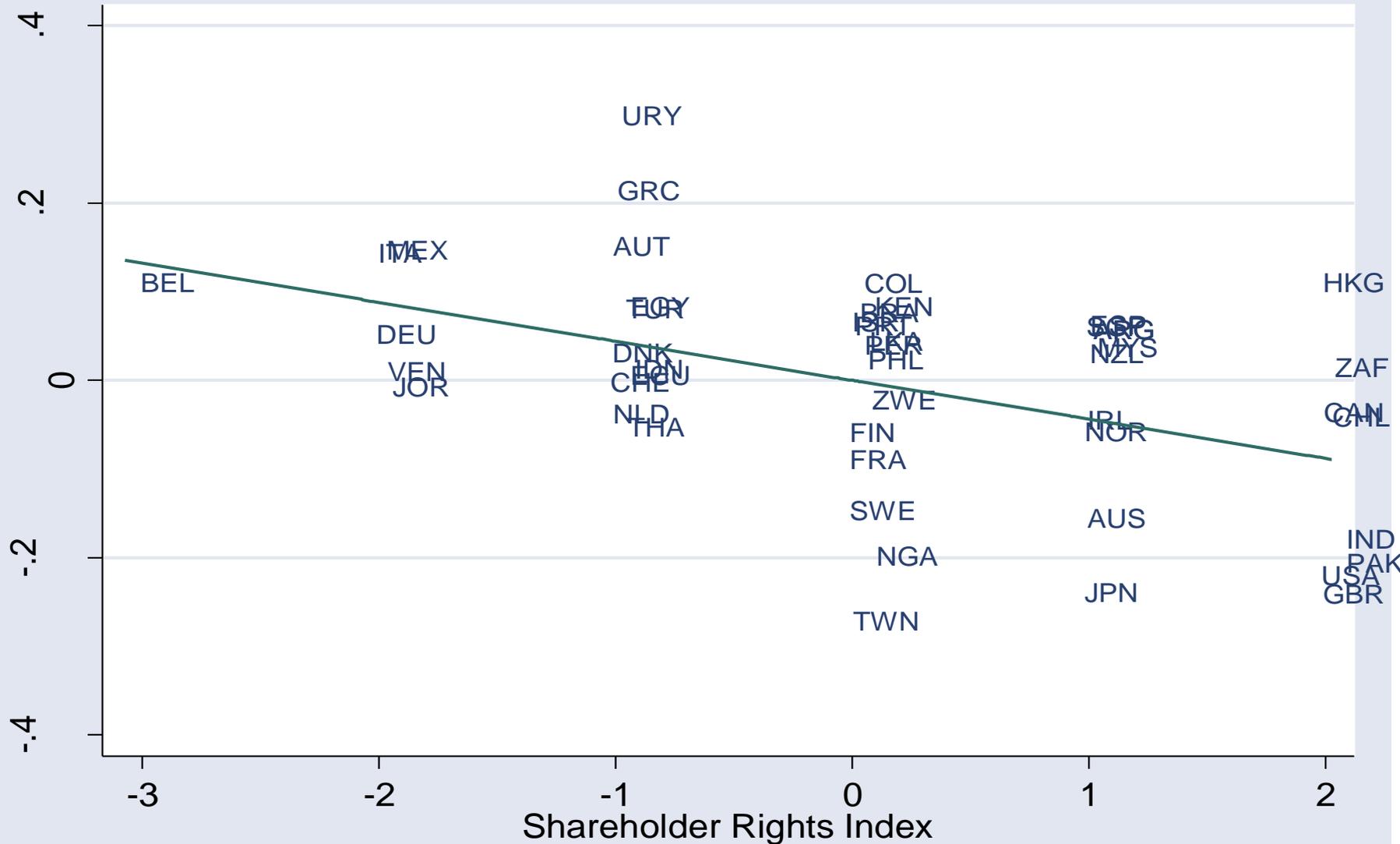
- ✓ The fundamental problem of CG is the expropriation of outside investors (creditors and shareholders) by insiders.
- ✓ Examples include:
 - ✓ Transfer pricing;
 - ✓ Transfer of assets;
 - ✓ Targeted issues and repurchases of securities;
 - ✓ Pursuit of non-profit maximizing projects.
 - ✓ Consumption of perks / CEO compensation.
- ✓ The principal goal of investor protection is to restrict expropriation so as to facilitate external finance.

Shareholder Rights and The Number of Listed Firms



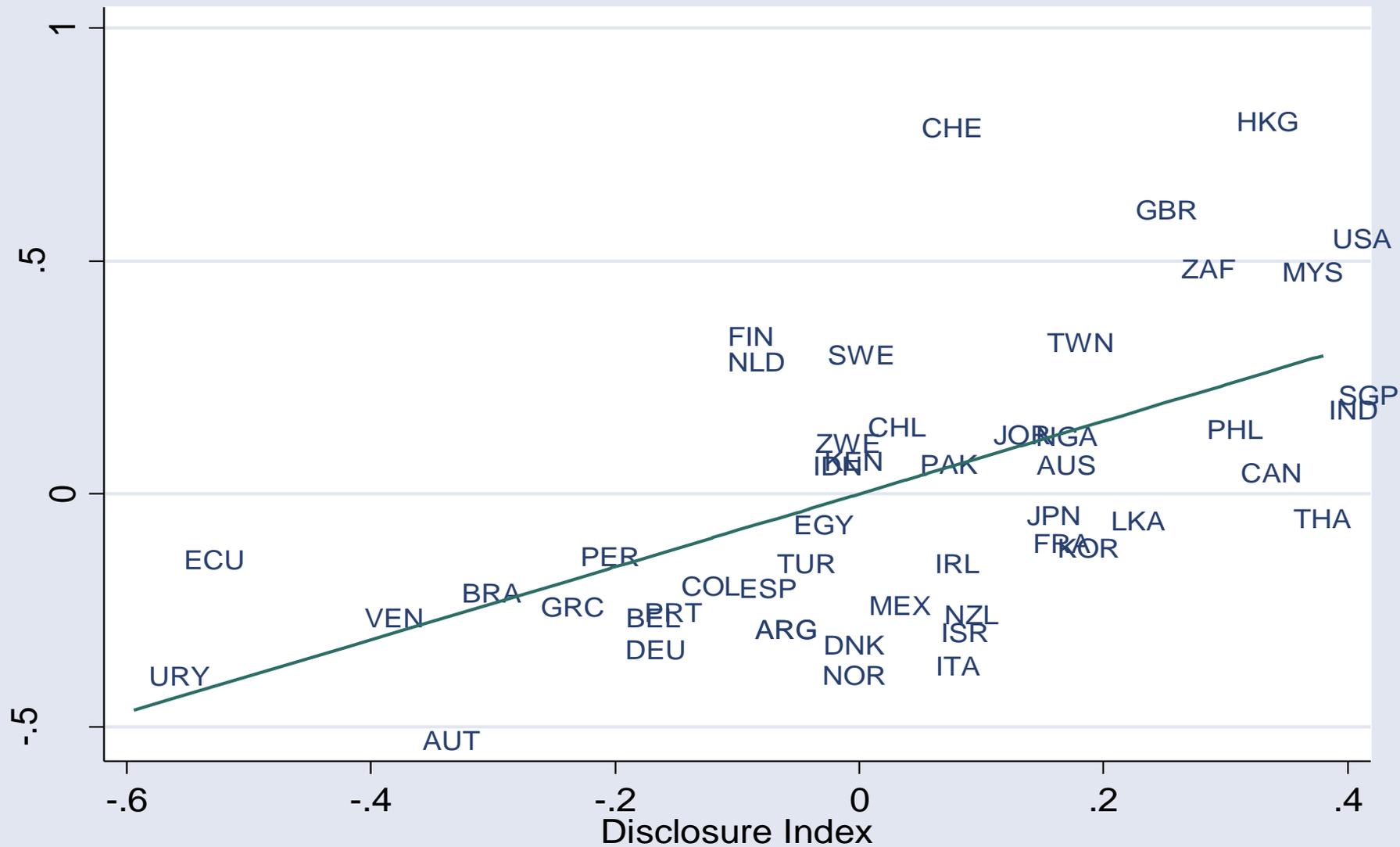
coef = .46014078, (robust) se = .12186662, t = 3.78

Shareholder rights and Ownership Concentration



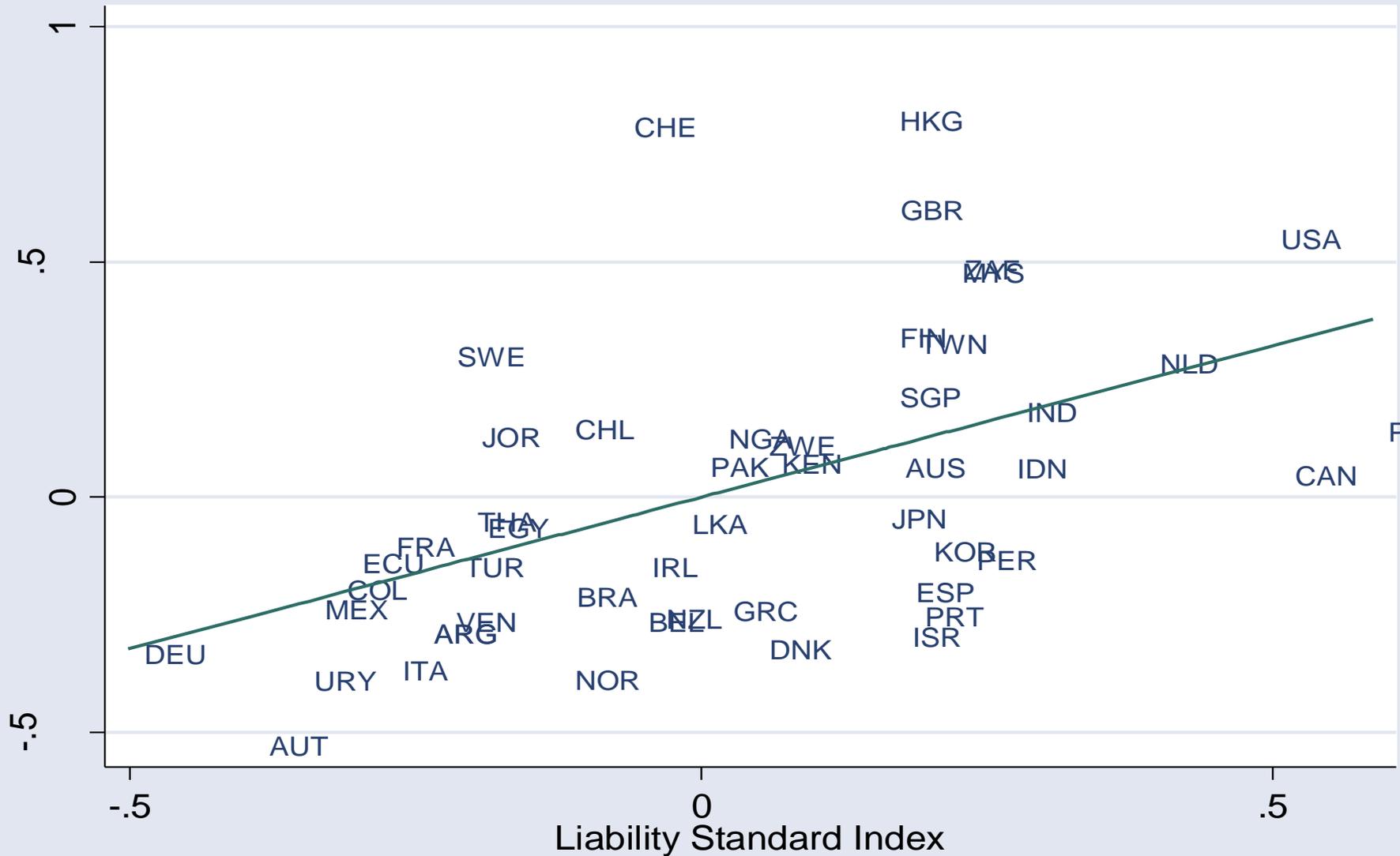
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Disclosure of Conflicts of Interest and Market Capitalization



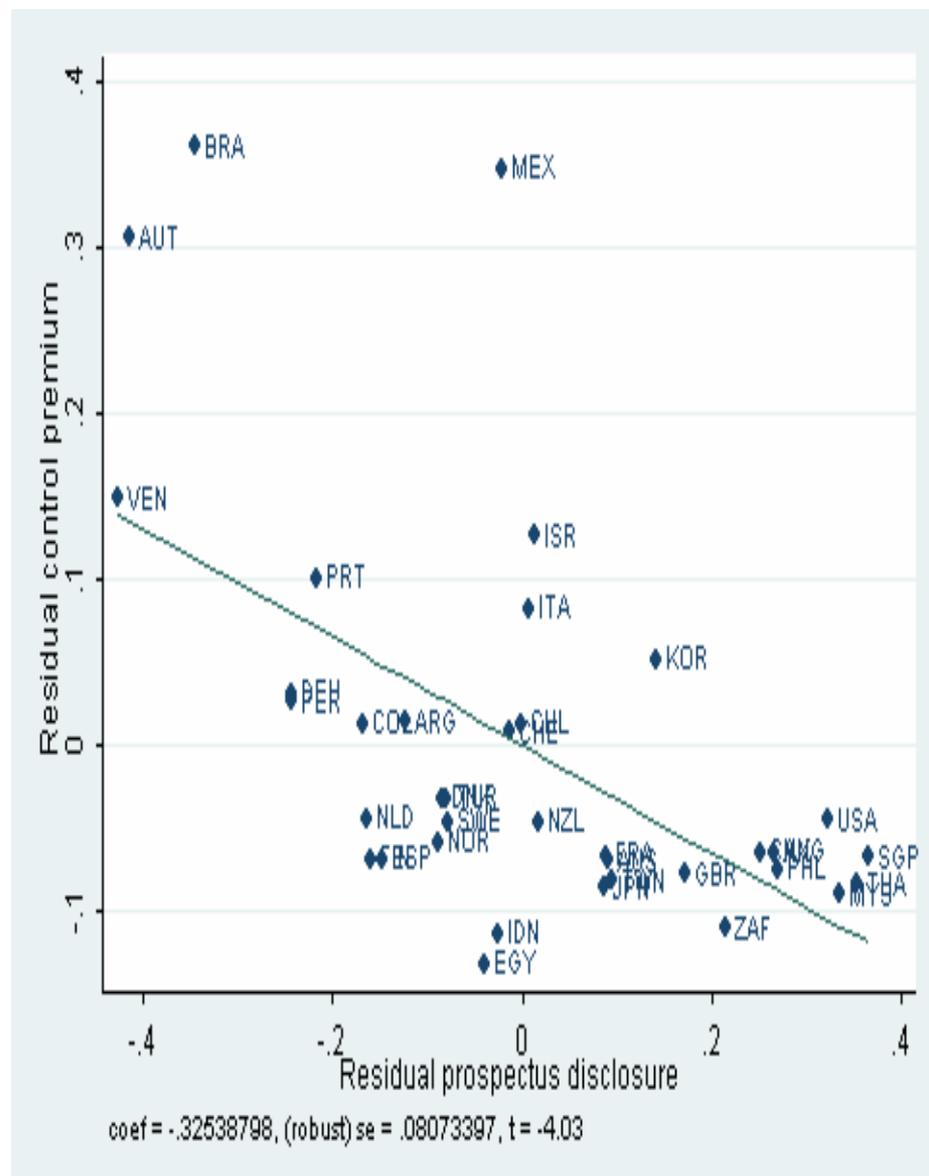
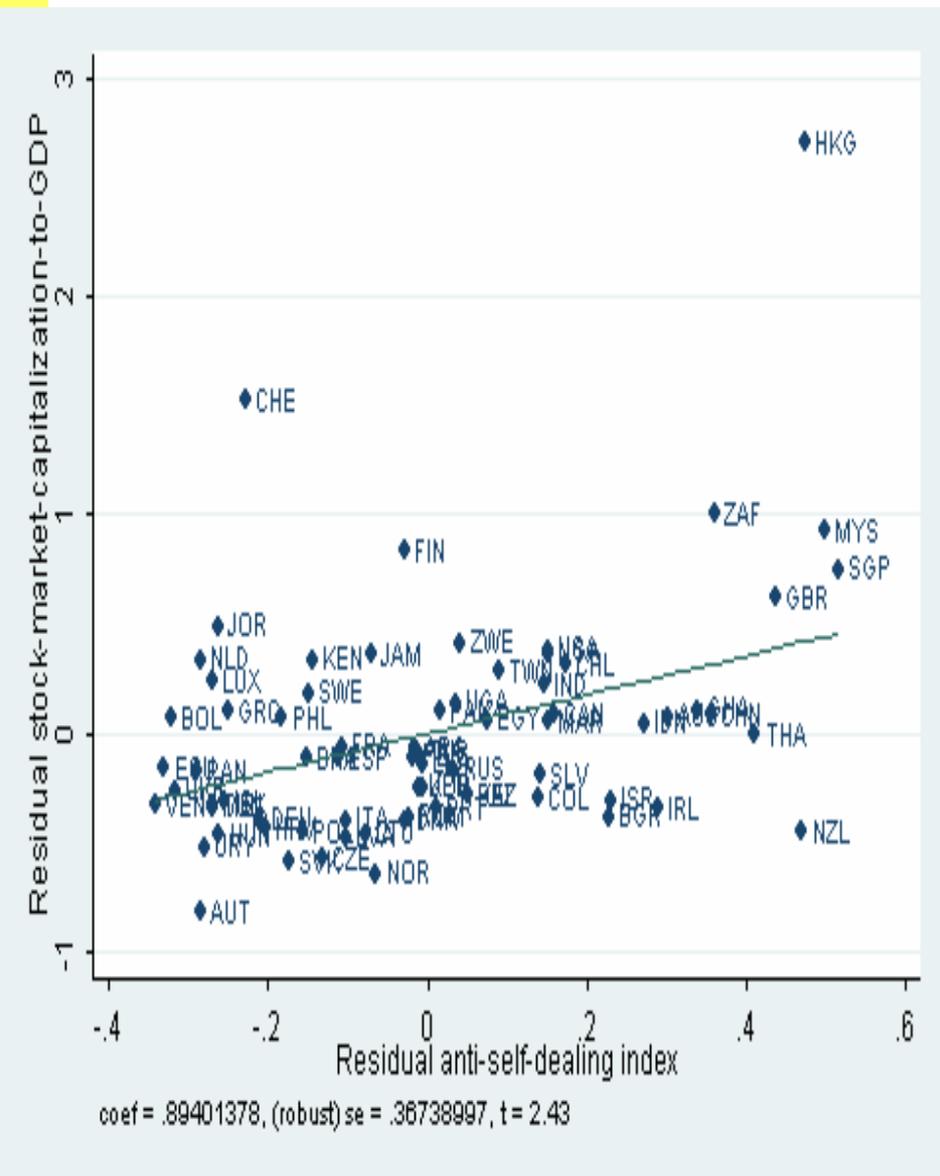
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Liability Standards and Market Capitalization

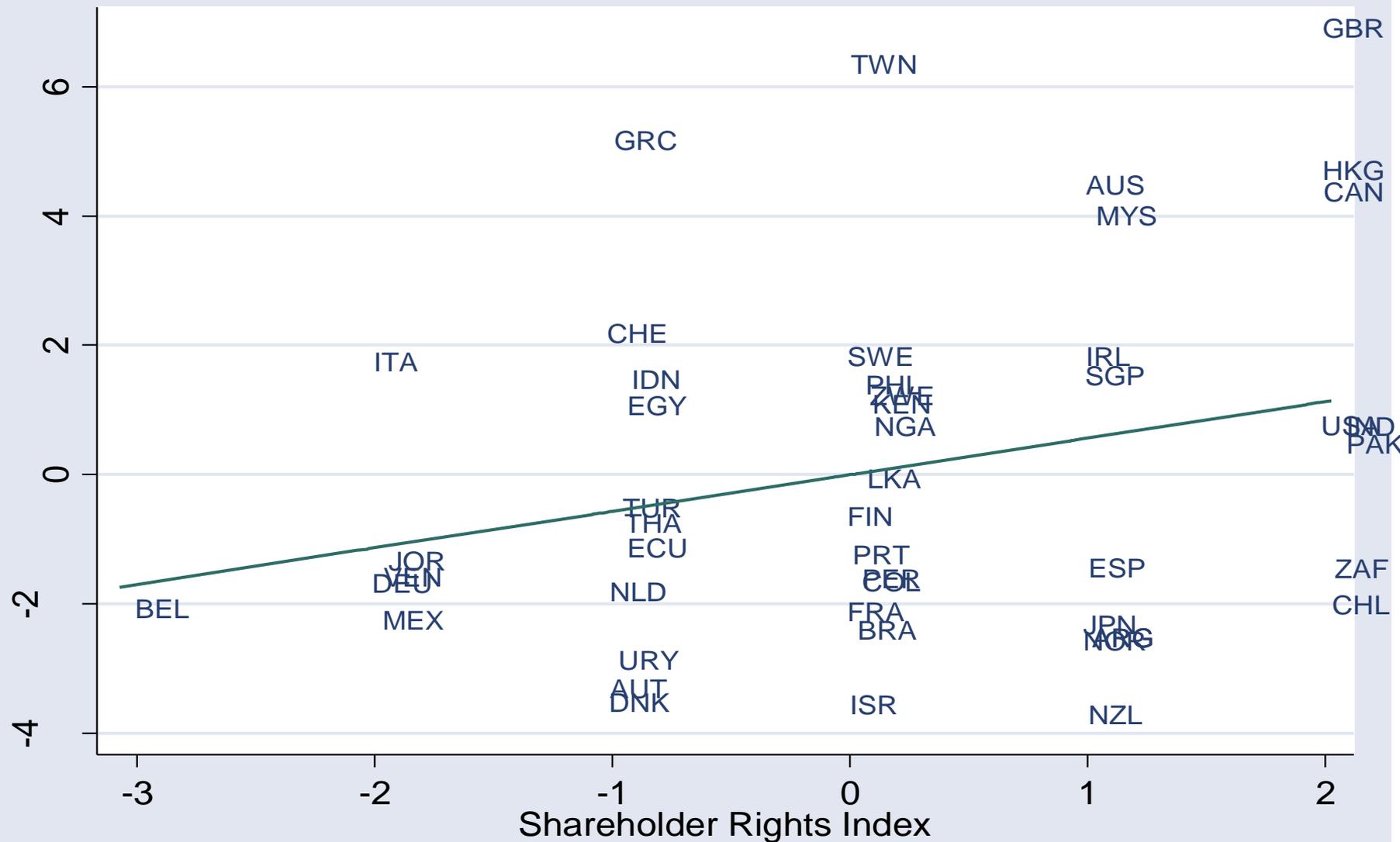


coef = .64485842, (robust) se = .12922437, t = 4.99

Financial Institutions and Capital Markets Development: Size and Breath of Stock Markets



Shareholder Rights and IPO value



coef = .56476115, (robust) se = .27698973, t = 2.04

Blueprint of Policy Reform: Measurement ahead of Policy

- This research sheds light on the nature of good reforms, and on the specific policy levers.
 - Helps understand why so many **developing countries** end up with **inefficiently high levels of regulation**, especially in the civil law world.
 - Even in the **developed countries**, the **high levels of regulation** of many activities (labor markets and entry) were probably adopted in a less orderly environment, or for reasons of consistency or habit, and as such are excessive for modern markets.
 - In **finance**, institutions that replaced markets must now be replaced by those that sustain them.
 - Developing countries: mismatch between institutions and needs is even greater.
 - The heavy-handed regulatory policy that might work tolerably well in some countries in Europe translates into over-regulation, corruption, and suppression of entrepreneurship in the developing world.
- **Note:** even when the measured rules are not the entire problem, and thoughtless formalistic reforms likely to fail, these rules can provide relevant data and point closer where the problem actually lies.