CHAPTER SEVEN

Privatization and Corporate Governance: The Lessons from Securities Market Failure

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A PARADIGM SHIFT IS NOW UNDER WAY IN THE MANNER IN WHICH FINANCIAL ECONOMICS VIEWS CORPORATE GOVERNANCE, WITH THE NEW SCHOLARSHIP EMPIASIZING BOTH THE CENTRALITY OF LEGAL PROTECTIONS FOR MINORITY SHARE- HOLDERS AND THE POSSIBILITY THAT REGULATION CAN OUTPERFORM PRIVATE CONTRACTING. HOWEVER, SUBSTANTIVE DIFFERENCES IN CORPORATE LAW MAY BE LESS IMPORTANT THAN THE DIFFERENCES IN THE LEVEL OF REGULATION THAT DIFFERENT NATIONS IMPose ON THEIR SECURITIES MARKETS. UNDER THIS LATTER HYPOTHE- SIS, THE FOCUS SHIFTS FROM THE MINORITY SHAREHOLDER TO THE INVESTOR GENERALLY. THE CRITICAL QUESTION BECOMES, DOES LOCAL LAW ESTABLISH ADEQUATE DISCLOSURE AND MARKET TRANSPARENCY STANDARDS, RESTRICT INSIDER TRADING, AND REGULATE TAKEOVERS AND CORPORATE CONTROL CONTENDERS ADEQUATELY? IF IT DOES, THEN ARGUABLY THE EXPOSURE OF SHAREHOLDERS TO SELF-FIDELING TRANSACTIONS AT THE CORPORATE LEVEL MAY HAVE ONLY A SECOND-LEVEL SIGNIFICANCE. THIS CHAPTER REVEALS THAT CONSIDERABLE EVIDENCE IN THE POLISH AND CZECH EXPERIENCES IS CONSISTENT WITH THE HYPOTHESIS THAT INADEQUATE SECURITIES REGULATION PLAYS THE PRIMARY ROLE IN EXPLAINING PRIVATIZATION FAILURES.

I. INTRODUCTION: CORPORATE GOVERNANCE REDEVELOPED

A specter is haunting the neoclassical theory of the corporation. It is the specter that law matters—that a positive theory of the firm is incomplete unless it incorporates and explains the role of legal variables. Recent research on corporate governance has found systematic differences between nations in ownership concentration, capital market development, the value of voting rights, and the use of external finance. More important, these differences seem to correlate closely with the strength of the legal protections given minority to investors. In turn, this level of legal protection seems to depend upon, and vary systematically with, the nature and origins of each nation’s legal system. In par-
ticular, common-law legal systems seem to vastly outperform civil-law legal systems (and particularly French civil-law systems) in providing investor protection and, in turn, encouraging capital market growth and ownership dispersion. Most important, this new scholarship has found that the size, depth, and liquidity of securities markets correlates directly with the quality of the legal protections given to shareholders. In consequence, because the nature and quality of legal protection differs widely across nations, the corporate world subdivides today into rival systems of dispersed ownership and concentrated ownership, with different structures of corporate governance characteristic of each. A paradigm shift is now under way in the manner in which financial economics views corporate governance, with the new scholarship emphasizing both the centrality of legal protections for minority shareholders and the possibility that regulation can outperform private contracting. Although in this chapter I recognize the importance of this transition, I am far more skeptical about whether this new scholarship has identified the critical elements that have given the "common law" nations a comparative advantage over the "civil law" world. There, a mystery remains. One possibility is that substantive differences in corporate law matter far less than differences in enforcement practice. In turn, enforcement may depend more upon the strength of the incentives to assert legal remedies than upon the availability of legal remedies themselves. Even this hypothesis, however, oversimplifies, because once one closely examines the differences between various systems of corporate governance, the assumed homogeneity of even common-law legal systems begins to break down. Another possibility is that differences in substantive corporate law are less important than the differences in the level of regulation that different nations impose on their securities markets. Under this latter hypothesis, the focus shifts from the minority shareholder to the investor generally. The critical question becomes, does local law establish adequate disclosure and market transparency standards, restrict insider trading, and adequately regulate takeovers and corporate control contests? If it does, then arguably the exposure of shareholders to unfair self-dealing transactions at the corporate level may have only a second-level significance. This chapter finds considerable evidence in the Polish and Czech experiences that is consistent with this hypothesis. Inadequate securities regulation plays the primary role in explaining privatization failures, but some evidence also exists to suggest that deficiencies in Czech corporate law contributed to the systematic looting of Czech companies by their controlling shareholders.

Even if the critical protections upon which minority shareholders depend have not yet been clearly identified, the available data still strongly support the interpretation that law matters; that in some not yet well-understood manner, certain legal systems have encouraged dispersed ownership, while other systems have rendered it an unstable and transitory phenomenon. This new emphasis on legal variables has potentially subversive implications for at least some aspects of neoclassical corporate finance theory. Much of the modern law-and-economics literature on corporate governance has assumed that financial-market regulation was unnecessary and that the role of corporate law was simply to offer a model form contract to investors to enable them to economize on contracting costs. This conclusion that regulation was superfluous, or worse, rested on twin premises: (1) sophisticated parties could write financial contracts that were far more detailed, sophisticated, and fine-tuned to their specific circumstances than any body of standardized regulations could hope to be and (2) entrepreneurs had adequate incentives to minimize agency costs (in part by bonding themselves and otherwise limiting their discretion) in order to maximize the value for their stock when they brought their fledgling firm to the capital markets. In short, because, under the standard Jensen and Meckling model of the firm, entrepreneurs bore the weight of agency costs, they had good reason to surrender any discretion to expropriate wealth from their investors and to bond themselves to serve their shareholders faithfully; hence, regulation seemed unnecessary. From this perspective, the survival of regulation could be explained best by reference to public choice theories about interest groups and rent-seeking.

This claim that financial contracting largely renders regulation irrelevant cannot explain, however, the close correlation between a given country's level of capital market development and the nature of its legal system. The more logical conclusion is that law does matter, and legislation can somehow better promote economic efficiency than can reliance on financial contracting alone. By themselves, private contracting and the voluntary incentives for disclosure seem incapable of producing the level of continuing disclosure necessary to sustain active securities markets.

More important, standard economic models of financial contracting within firms do not fit the privatization context. Chiefly, this is because privatized firms do not evolve over time from smaller firms, beginning with the usual incubation period as the venture capital stage and progressing through the initial public offering (IPO), but instead are created Minerva-like by governmental fiat. Typically, voucher privatization (which has been the preferred technique) simply distributes shares (or coupons to purchase shares) to all or most of the adult citizens in the country. Dispersed ownership is more transient and vulnerable in this context, because it arrives overnight at the outset of the firm's existence. Hence, managers neither contract with shareholders nor pledge
a reputational capital that they have carefully built up over years of service; rather, managers and shareholders are thrown together as legal strangers.16

This point has important implications for a policy debate that has begun among scholars who have studied the transitional process. Should privatization be "fast" or "slow"?17 Should policymakers adopt a "Damn the torpedoes, full speed ahead" approach that accepts the inevitability of some overreaching by controlling shareholders, but justifies this cost as necessary to realize and expedite the efficiency gains incident to privatization? Or should privatization proceed more cautiously because of the risks of market failure and political corruption that may result when control seekers are tempted to bribe and seduce the judicial and regulatory systems to achieve the private benefit of control? These tempting private benefits arise, of course, precisely to the extent that privatization preceded the creation of an adequate legal foundation. The cases examined in this chapter illustrate this tension and lead toward favoring a prudential course of phased privatization, which does not make a hasty and potentially corrupting scramble to control the likely consequence of creating a dispersed-ownership structure.

This chapter will proceed through four stages. In section II I examine some of the difficulties in attempting to distinguish common-law civil-law systems in terms of any crucial factors that lead one to outperform the other. I then focus, in section III on the Czech and Polish experiences, along with earlier, more tentative efforts at privatization, in order to understand what has chiefly gone wrong. In section IV I discuss the techniques recently used for expropriating value from privatized firms and suggest that these techniques reveal some deficiencies in the corporate governance norms of civil-law systems. Finally, in section V I suggest functional reforms and priorities, but these proposals will not give primary emphasis to specific doctrinal rules. Indeed, the premise will be that wholesale adoption of U.S. or U.K. legal rules is not feasible and might not be effective in any event.

II. Are Common-Law Systems Homogeneous?

The new comparative research on corporate governance has found that some legal systems give minority shareholders greater protection from fraud and expropriation than others and has assumed that the critical differences largely inheres in the statutory law of these rival systems.18 This assumes, however, what is to be proved. For example, differences in substantive law could be far less important than differences in enforcement practice. But once we focus on enforcement practice, a blunt, but overlooked, truth quickly confronts us: common-law legal systems may not be that much alike. Thus, while it has been an implicit premise of this new learning that the United States and the United Kingdom, as the two leading common-law systems and the two leading economies characterized by dispersed share ownership, are highly similar, this premise is very debatable. To be sure, both systems share a common legal history. But to stop at this point is to ignore volumes of more recent and highly relevant history over which their two paths have diverged. For much of the late nineteenth-century robber baron era in the United States, controlling shareholders regularly overreached and plundered minority shareholders and creditors. Colorful rogues—such as Jay Gould, Jim Fisk, and Daniel Drew—regularly manipulated the market and perfected the legal technology for "watering" the stock of minority shareholders.19 Meanwhile, these predators battled for control of railroad empires against even more imperious barons, such as Comstockore Vanderbilt, with each side buying and corrupting local judges.20 Throughout that period, much of which seems to have been recently replayed in Russia and central Europe, the common-law proved a frail reed upon which minority shareholders could not safely rely. Over time, investment bankers (most notably, the House of Morgan) and the New York Stock Exchange brought some semblance of law and order to this Wild West environment, and legal standards (particularly those applicable to stock issues and fiduciary standards) were consciously tightened by courts and state legislators. Still, as of 1900, little suggested that shareholders in the United States received greater protection than shareholders in, say, France.

Another aspect of this puzzle emerges if we look at the legal system in contemporary Russia. Although the Russian legal environment seems even closer to the Hobbesian state of nature, with the looting of corporations and financial institutions being a fairly common event, Russian corporate law has largely borrowed (in a simplified fashion) the principles features and protections of U.S. and U.K. corporate law.21 Apparently, expropriation can occur even when the "law on the books" is nearly optimal. Perhaps this should not surprise us, as the legal realists have taught us for most of the twentieth century that the "law on the books" is often different from, and less important than, the "law in practice."22

One likely answer to this puzzle of when law matters (and why) may lie in the hypothesis that what really counts is not the content of the substantive law, but the adequacy of the enforcement mechanisms that underlie it.23 The concept of enforcement mechanisms needs, however, to be understood in a broader sense than simply as the availability of specific legal remedies. For example, the one characteristic that the rob-
her baron era in the United States shares with contemporary Russia is that, in both, the central government was weak and largely unable to enforce its commands in outlying areas. In the late nineteenth century, the federal government in the United States was almost powerless to control private business entities; no centralized body, such as the Securities and Exchange Commission (SEC) had jurisdiction over investor protection, and business rivals could establish strong political footholds in one state and largely ignore the commands of judges in a different state. In contemporary Russia, the central government appears similarly unable to control local provincial administrators, who may confiscate or extort assets from corporations operating in their area of effective control.¹⁹

If we focus on enforcement, however, it immediately becomes clear that the differences between the United States and the United Kingdom are probably as great as between the United States and France (a nation generally thought to enforce its investor-protection laws only weakly). In the United States, class and derivative actions are permitted, and plaintiffs' attorneys may charge contingent fees, which are usually awarded by the court based on a percentage of the recovery that the attorney obtains for the class. Under the standard "American Rule," each side bears its own legal fees (which means that the plaintiff's attorney faces only the loss of time and expenses invested in the action if the action is unsuccessful and is not generally liable for the winner's legal expenses).²⁰ In the United Kingdom, the reverse is generally true. Class actions and contingent fees are not authorized, and the losing side must normally compensate the winning side for its expenses. When the individual plaintiff sues the large corporate defendant, the latter will likely incur the larger legal fees, and this disproportionate logic turns the prospect of fee-shifting under the English rule into a prohibitive deterrent to litigation. As a result, while in the United States a highly entrepreneurial system of private enforcement has evolved that largely overcomes the collective-action problems that dissuade individual investors from suing,²¹ nothing comparable exists in the United Kingdom.

Another sharp contrast involves the level of judicial activism in the two countries. For common-law systems to behave similarly, it would seem logically necessary for them to accord a similar role to the judge. But it is not clear that they do. Although the United States and the United Kingdom share a common-law tradition, judges in these two systems appear to behave quite differently. Comparative-law scholars rate U.S. courts near the top of the scale in terms of "judicial daring"—that is, the willingness of judges to create new legal rules in the absence of legislation—but place the United Kingdom near the bottom of this same scale.²² In short, the more that one looks at the supposedly obvi-

ous differences between common-law and civil-law countries, the more that those differences begin to blur.

On the other hand, the United Kingdom has other institutions—most notably, its Takeover Panel—that appear to be highly effective and that lack any close parallel in the United States. In general, takeover defensive tactics are much more restricted in the United Kingdom than in the United States. Finally, given the more concentrated character of the British financial community (in terms of both institutional ownership and physical location in the city of London, reputational effects may matter more in the United Kingdom than in the United States. These differences may be important, but they have little to do with the line between the common law and the civil law.

The point here is not to compare the enforcement mechanisms of the United States and of the United Kingdom, but only to indicate that they may be very different. In turn, this implies a conceptual problem with the new academic research that broadly and boldly contrasts common-law countries with civil-law countries. Although real differences are clearly observable in terms of ownership concentration, the depth of markets, and the value of control, the presumed legal homogeneity of either common-law or civil-law countries may be more illusory than real. For example, many of those substantive legal rules that the United States and the United Kingdom share may have only trivial significance (or may have importance in one legal system and not the other).²³ Thus, to return to a distinction that I have made in earlier work, formal legal convergence may be less important than functional convergence.²⁴ Although the United States and the United Kingdom (and other common-law countries) have similar legal systems that share a common origin, their common history may be less important than the fact that they have developed quite different mechanisms for dealing with the same "agency costs" problems that is the end achieve functionally similar results. For example, the issuance of a materially false financial statement may cause a significant drop in the company's stock price upon its discovery in both nations. In the United States, it may elect a class action; in the United Kingdom, institutional investors may protest to the board and demand corrective action. However, in both countries, responsible senior management may lose their jobs in consequence over about the same period. Similarly, to both countries, a chief executive officer whose company's stock price and earnings underperform the industry averages for a given number of successive quarters will likely be removed from office—although the mechanism of removal (a board coup d'état or a hostile takeover) may differ.²⁵

In short, the danger in focusing on legal commonality is that it may obscure very different functional mechanisms that are in fact more re-
III. FALLACIES AND BLINDSPOTS: A SHORT HISTORY OF MASS PRIVATIZATION

In 1995, the Prague Stock Exchange had 1,716 listings.10 Blessed with relatively low inflation and nearly full employment, the Czech Republic's strong macroeconomic position made it seem the country in central of Eastern Europe most likely to make a smooth transition into a market-oriented economy. Yet by early 1999, the number of listings on the Prague Stock Exchange had fallen by more than 80 percent to 101, and observers estimated that fewer than a dozen of these enjoyed any liquidity.11 Correspondingly, over the same period, the value of investments in an index of the leading fifty stocks on the Prague Stock Exchange fell by more than 60 percent.12 Trading dried up, and the viability of the Prague Stock Exchange was itself threatened. Where there had been 1,486 brokers in 1997, there were only 358 in mid-1999.13

What happened? The fundamental fallacy in Czech privatization was that securitization markets would develop spontaneously, simply because voucher privatization would create an initially dispersed ownership structure. By widely distributing the stock in privatized companies to a broad segment of the Czech adult populace, Czech planners expected that an active secondary market would develop naturally. The militantly laissez-faire attitude of the initial Czech government also made it highly resistant to any regulation of this market.

In fact, for an initial period of high optimism, which lasted into 1995, share prices did rise. But then, after a series of scandals, the Czech bubble began to burst. First, foreign portfolio investors began to flee the Czech market. Foreign direct and portfolio investment dropped from $103 million in 1995 to $57 million in 1996 and then turned negative in 1997.14 By 1998, the Czech economy had entered a general recession.15 In its wake, momentum gathered to reform the Czech securities market, and reform legislation was adopted in 1998 that established a Czech SEC and curbed some of the more egregious abuses.

Behind this massive disinvestment in the Czech market lay a pervasive loss of investor confidence, as small, dispersed owners witnessed widespread looting of Czech investment funds and the systematic exploitation of the remaining minority shareholders in Czech firms once any faction acquired a controlling position. In consequence, small shareholders systematically divested their shares and moved savings to other forms of investment. At the outset of mass privatization in the Czech Republic, more than 7 million Czech citizens purchased shares through voucher privatization, but by 1999, the number of Czech shareholders had fallen to "barely five million."16
The Czech experience then seems a paradigm of a market failure caused by inadequacies in the legal system; it is still important to identify what precisely went wrong. At this period of initial optimism, investors clearly lost confidence in the Czech market, causing it to decline sharply, even though the underlying macroeconomic conditions remained relatively stable on a regional basis. Moreover, the apparent Czech failure contrasts sharply with the experience of neighboring Poland, where the privatization process was slower and where stronger disclosure and governance standards were established as preconditions. This section will therefore move from a brief review of this seemingly natural experiment to a more detailed assessment of what differentiated these two efforts and then to a broader look at other privatization programs.

A. Poland versus the Czech Republic: Divorced Approaches to Privatization

In geopolitical terms, Poland and the Czech Republic have a lot in common, as similar central European countries with a shared Slavic culture and historical experience, both nations being former members of the Soviet bloc. But their approaches to privatization could not have been more divergent. The Czech Republic rushed into privatization in the early 1990s with regulatory controls being developed on an ad hoc basis in response to a series of crises and scandals. Determined to move assets into the private sector as quickly as possible, Czech authorities privatized some 1,491 state-owned companies in the first wave of Czech privatization, and another 861 in the second wave—thereby increasing the private-sector share of Czech gross domestic product (GDP) from 12 percent in 1990 to 74 percent by 1998. In fairness, this was a considerable logistical achievement.

In contrast, Poland moved far more slowly and equivocally, privatizing only some five hundred firms and only pursuant to a procedure that assigned a state-created investment fund as the controlling shareholder of each privatized firm. Rather than assuming that a secondary market would develop spontaneously, Poland designed voucher investment funds as a mechanism to solve the perceived powerlessness of the individual shareholder in a post-privatization program. To ensure that these state-created investment funds would control the privatized firms, Poland neither permitted the creation of private investment funds (which had sprung up overnight in the Czech Republic) nor initially allowed citizens to invest directly in the stock of the newly privatized firms. Rather, Polish law mandated that citizens could invest their voucher certificates only in state-created financial intermediaries, known as national investment funds (NIFs), which were to serve as controlling share...

Privatization and Corporate Governance
the reported prices on the Prague Stock Exchange reflected real values. Moreover, in this nontransparent world, informed trading predictably flourished because it was more profitable than in an efficient market.22

A second problem quickly arose that further compromised restructuring efforts. During the course of the two Czech privatization waves, some six hundred investment funds were created, and they competed vigorously to convince individual investors to convert their privatization vouchers into the funds' shares. Potentially, such vehicles could have become effective corporate monitors because they aggregated large stakes in Czech corporations and thereby potentially solved the collective action problem that the dispersed ownership resulting from voucher privatization necessarily implied. However, the largest investment funds were established by the principal Czech commercial and savings banks, which had obvious reputational advantages in convincing Czech citizens to deposit their vouchers with them.45 Owning only small stakes in their own investment funds, the banks had little incentive to undertake costly restructuring activities. Instead, many sought to use their investment fund's influence over its portfolio companies to secure banking clients for themselves. Rather than concentrating their holdings (and thus maximizing their influence), most bank-administered funds sought to diversify their holdings in order to hold stakes in as many firms as possible—in part to solicit banking clients for their parents.46 Also, to protect their banking parents from potential hostile takeovers, the bank-run funds cross-invested heavily in the common stocks of the other major banks and in that of their own banking parent. An incestuous web of cross-ownership quickly developed to insulate the major banks from hostile takeovers. Finally, most privatization funds (both bank-related funds and nonbank funds) found it more profitable to concentrate on trading than on restructuring, often-inefficient portfolio companies. The combination of a nontransparent market and their privileged position as insiders made such activities profitable, but constantly filled the media with news of recurring insider trading scandals.

If the bank-related funds were passive, the nonbank funds were far worse. A subsequent study by the Czech Ministry of Finance found a negative correlation between a privatized firm's performance and the percentage of its shares held by nonbank investment funds.47 In the first wave of Czech privatization, 3 percent of the funds became insolvent and were placed into "forced administration,"48 but, in the second wave, the rate of insolvency accelerated, and some ten funds accounting for more than 21 percent of market capitalization in that wave were placed in "forced administration." The common cause appears not to have been excessive leverage or investment failures, but "fumbling" out—the fraudulent siphoning off of assets.

The ease with which funds could be looted is shown by the similar ease with which they could escape regulation. Although Czech law did regulate the operation of investment funds, it did not restrict the ability of an investment fund to elect to deregister and become an unregulated holding company. Symptomatic of the civil law literal narrow-mindedness, the difference between an investment company and a holding company under Czech law was formal, not functional. Simply by surrendering one's license to operate as an investment company, an investment fund could escape virtually all regulation. Because share ownership of investment companies was extremely dispersed, a small control group, holding as little as 10 percent of the voting stock of an investment fund, could usually dominate shareholder meetings and pass a resolution to convert the fund into a holding company. Once unregulated, all forms of self-dealing were effectively made possible, and the entity might reincorporate outside the Czech Republic (as some did).

The extent of such conversions seems extraordinary. In terms of market share, fully 28 percent of the investment-privatization funds in the first wave of Czech privatization and 21 percent of the funds in the second wave were converted into unregulated holding companies.49 Although this may sound as if the rate of conversion declined, it must be remembered that an additional 21 percent of the funds in the second wave were placed in "forced administration" by the Czech authorities.50 On this basis, nearly half the funds in the second wave of Czech privatization either failed or escaped regulation by being converted into unregulated entities. Although major 'bank-run' funds generally stood apart from this race to convert, the banks' intentions, while nonfraudulent, seemed to have been in part to use their funds as vehicles with which to attract banking clients and other business for themselves.

The eventual upshot of these repeated scandals was that the administration of investment funds became a contentious political issue in the Czech Republic and helped to bring about the downfall of the government of Václav Klaus (which had generally opposed market regulation) and the passage of securities-reform legislation in 1998. But by then, public confidence in the securities market had been largely eroded.51 The Polish experience was in many respects the reverse of that of the Czechs. Privatization was delayed and delayed again, as demanding disclosure rules and fiduciary standards for directors were drafted. Polish citizens were given only one choice: which NIF (of the fifteen originally created) to invest in, a direct investment in either portfolio firms or private investment funds was not initially permitted. Trading was centralized on the Warsaw Stock Exchange, and price transparency appears never to have been a serious issue. Polish disclosure standards also won high marks from most observers, and the European Bank for Recon-
Stock Exchange). As of early 1999, one study finds that 117 stocks from Eastern Europe were listed on the Berlin Stock Exchange, of which 24 were from the Czech Republic but only 13 from considerably larger Poland. Prior to the onset of the Russian financial crisis in late 1998, Poland had 2 percent of its listed companies traded on German stock exchanges, while the Czech Republic had 5 percent (or more than twice as many). This disparity should not be surprising. Having the weaker legal protections, Czech companies had the greater need to list on a foreign exchange with "stronger" governance standards in order to attract foreign portfolio investors (most of whom had already fled the Czech market because of its lack of transparency).

This happy story contrasting the regulated and unregulated worlds encounters one serious difficulty that arose in late 1998. Beginning in approximately December 1998, the stock prices of the Polish NIFs fell drastically, and they currently trade at discounts to their net asset values, as steep as ever existed in the Czech Republic. Meanwhile, the surviving Czech investment funds now trade at relatively modest discounts to their net asset value (typically around 20%).

What explains this sudden reversal? Although any answer is speculative, most NIFs experienced board control contests in 1998 that replaced their old investment managers. Until late 1998, the Polish government held the majority of the voting power in NIFs. But since then, shareholders have replaced the management company in fourteen of the original fifteen NIFs. In effect, the same fear of opportunistic control struggles that eroded investor confidence in the Czech market appears to have devastated the value of Polish NIFs. No longer the stable pawns of the state, these NIFs appear to have suffered a sharp and fairly sudden loss of investor confidence.

Still, the number of firms traded on the Warsaw Stock Exchange has continued to grow, and its overall market capitalization now exceeds that of the Prague Stock Exchange. Nor has evidence yet surfaced indicating that privatized companies have been looted or cancelled in Poland. Nonetheless, the bottom-line conclusion must be a cautious one: in transitional economies, it may take little to disturb investor confidence and produce a flight for the exits. As they have been "deregulated" (or, perhaps more accurately, "privatized"), the Polish NIFs may be repeating the sorry history of the Czech funds.

B. What Really Distinguishes the Czech and Polish Experiences?

To this point, the Czech and Polish experiences have been differentiated in terms of the highly spontaneous character of Czech privatization versus the carefully planned—indeed, constrained—character of Polish
privatization. But both nations have in common one fact that is troubling for the new scholarship that emphasizes the importance of differences in substantive corporate law: they each had a corporation law heavily based on the German civil-law structure. Put simply, their experiences were very different, but their corporate laws were largely the same. As a result, because the corporate laws of Poland and the Czech Republic each provide only weak protection for minority shareholders, their different experiences cannot be used to corroborate the claim that differences in substantive corporate law are the key causal factors that determine the success or failure of privatization.

Yet if Poland and the Czech Republic had similar corporate laws, their approaches to securities regulation were entirely different. Not only did Poland impose high disclosure standards from the outset (including quarterly reporting), it also created an SEC-like agency to enforce its laws from the beginning of its privatization experience. In addition, Poland adopted ownership disclosure provisions that resembled Section 13(d) of the United States Williams Act in order to require ownership transparency—that is, the disclosure by substantial shareholders and potential acquirers of their beneficial ownership of specified levels of a company's shares. Finally, Poland (but not the Czech Republic) followed the British model of takeover regulation by requiring any shareholder who acquired more than a specified level of stock to make a mandatory bid for the remaining shares. In sum, as Fawor has shown, Poland had "weak" corporate law, but "strong" securities law.

To give an overview, these restrictions on the undisclosed acquisition of control and the mandatory requirement that a control acquirer offer to purchase the remaining shareholders may have been responsible for some of the differences in the Czhech and Polish experiences. Seemingly, these restrictions precluded (or at least slowed) the frantic scramble for control that occurred in the Czech Republic. To the extent that this is true, the Polish experience may suggest the need for refinements in the "minority protection" model developed by those scholars of corporate governance who have focused, somewhat single-mindedly, on differences in substantive corporate law as the primary determinant of ownership structure. In a comparison of systems of corporate governance, many of the most important differences may lie at the level of regulatory structure. Here, rules prohibiting insider trading, requiring ownership transparency, and restricting competitive bidding may do more to protect minority shareholders from expropriation than would the same jurisdiction's substantive corporate law rules. Indeed, as suggested earlier, the most important common denominator between the "protective" legal regimes in the United States and the United Kingdom may be their highly similar securities laws, not their common law origins.

Another hypothesis, however, must also be noted: more important than these legal differences may have been the creation of the Polish NIFs. By holding controlling stakes, these state-created financial intermediaries blocked the path of entrepreneurs who otherwise might have competed to seize control of newly privatized companies. A critical, if possibly unintended, role of the NIFs was to provide an assurance to smaller shareholders that they need not fear the potential expropriation of their investment in a privatized company, at least because of its vulnerability to a predatory control sector. Indeed, much of the scramble for control in the Czech Republic seems to have been defensively motivated. Each large shareholder essentially realized that if it did not acquire control, someone else would, with resulting injury to it. Each shareholder would know that the acquisition of control by some other shareholder would imply a sharp decline in the value of its minority position. As a result, the fear of loss may have provided a greater incentive to compete for control than the expectation of any synergistic or opportunistic gain.

In this light, the inefficient exposure to loss that the Czech system imposed on minority shareholders may also explain the absence, noted earlier, of equity offerings for cash in the Czech Republic as contrasted with their frequency in Poland. Because an offering of equity securities inherently dilutes existing shareholders, it exposes them to an increased risk of expropriation; correspondingly, it also potentially disrupts any equilibrium that may have been achieved among large shareholders. Having acquired a majority position, a controlling shareholder might prefer to rely on high-cost bank financings rather than to make use of dilutive equity financing, because dilution of its ownership could interfere with its ability to realize the private benefits of control. This fear was not a danger in the Polish context, where the NIFs gave all shareholders greater assurance of continuity for at least an interim period. Thus, one implication of the Czech experience may be that unregulated control contests and the rapid transition from dispersed to concentrated ownership can give rise to externalities—both political and economic.

Correspondingly, the sharp decline in the stock prices of Polish NIFs, once shareholders were permitted to take control of them from the government, also reinforces the interpretation that unregulated control contests and the rapid transition from dispersed to concentrated ownership can give rise to externalities. Had the Polish government provided for a more phased transition (such as through transitional ownership ceilings or use of staggered boards), the severity of this decline might have been reduced.
C. Other Privatization Experiences: Do Securities Markets Develop Naturally?

Although the Czech and Polish experiences probably supply the closest approximation to a natural experiment that can be found in this area, their experiences are not unique. A brief review of earlier privatization efforts finds similar cases in which emerging securities markets collapsed after a loss of investor confidence, including cases in the United States. Although in the public mind the term "privatization" probably first came into popular usage with the decision of the government of Margaret Thatcher in Great Britain in 1979 to sell off government-owned enterprises, important earlier instances can be identified. The first large-scale privatization offering to public investors seems to have occurred in 1961, when the Konrad Adenauer government in the Federal Republic of Germany sold a majority stake in Volkswagen in a public offering that was aimed at small investors in Germany. This was followed by an even larger offering in 1965 of the government-owned shares of VEBA A.G., a German heavy-mining company. Both offerings were initially successful, but share prices fell dramatically thereafter, forcing the Adenauer government to develop "a rescue operation... aimed at protecting small shareholders." The experience appears to have dissuaded both Germany and other European governments from embarking on similar programs until the Thatcher administration initiated its ideologically motivated wave of privatizations in 1979.

During the early 1970s, the government of Augusto Pinochet in Chile sought to reprivatize industries that had earlier been nationalized by the Salvador Allende administration. Sales were made at extremely discounted prices, and when the Chilean economy later entered a debt-payment crisis in the early 1980s, it renationalized many of these same industries. Not until the late 1980s (at roughly the same time as the Thatcher government) did Chile effect a more successful privatization program through the public sale of shares in state-owned enterprises. However, the key event in this later, successful privatization was the 1990 privatization of Telefónica de Chile, which was largely targeted at U.S. investors through the use of American depositary receipts. Mexico's very large and successful privatization program in the 1990s has similarly been affected through privatizations of large, state-owned companies that were directly listed on the New York Stock Exchange.

Mass-privatization efforts that have not been implemented through established exchanges have fared less well. The most notable example is, of course, that in Russia. By virtually all accounts, Russian privatization has involved a spectacular series of blunders and been thwarted by pervasive corruption. As a result, most recent discussions of privatization have been largely preoccupied with the Russian experience. But the lessons from the Russian failure are more difficult to draw because the Russian privatization effort was flawed from the outset by critical design failures and macroeconomic conditions that were not present in either Poland or the Czech Republic. First, Russian privatization had a significantly different design than did Czech privatization in that substantial blocks of stock were allocated to the incumbent managers as a political accommodation that was essential to the implementation of privatization. The result was probably easily predicted: within two to three years after mass privatization, most minority shareholders had sold their shares to the insiders, thereby producing the same highly concentrated ownership structures that are the norm elsewhere. Second, in contrast to circumstances in other recent privatization experiences, the Russian government lacked control over its outlying regions. In these regions, privatized companies have been at least as subject to expropriation by the local government (or coalitions led by, or affiliated with, it) as by controlling shareholders. Third, the legal system in Russia was almost uniquely primitive, indeed to the point that few contractual obligations could be routinely enforced and resort to extralegal means (most notably, violence) was the norm, not the exception. Finally, the macroeconomic condition in Russia proved to be particularly perverse. As a result, in 1998, the Russian government defaulted on its domestic and international debt, and the RTS stock market index fell almost 90 percent from its level of eleven months earlier. When an experiment fails from multiple causes, it is difficult to attribute primary responsibility to any one of them.

In contrast, what makes the Czech story more interesting than the Russian is that the same transition from dispersed to concentrated ownership occurred even without the built-in bias for insider ownership or the poor macroeconomic conditions that characterized the Russian case. Nor is the Czech experience unique. To the extent that Czech privatization malfunctioned, lack of regulation would appear to play a greater causal role, because other explanations are simply not as available. More generally, except when companies have been privatized through offerings listed on international stock exchanges, the Czech progression to concentrated ownership seems to be the dominant pattern, with the exceptions being few in number. Poland appears to be the most notable anomaly, but its story has not yet played out fully. As discussed next, this pattern raises the question of whether this transition is an inevitable progression.
D. The Reappearance of Concentrated Ownership

Both in Russia and in the Czech Republic, mass privatization through the sale or distribution of privatization vouchers to the citizenry inevitably created a highly dispersed ownership structure—just for a transitory period. Over time, concentrated ownership reemerged. Because numerous studies have concluded that privatized firms become more efficient, it is not surprising that some studies attribute this increased efficiency to the emergence of concentrated ownership. For example, one detailed study that examined the performance over the period from 1992 to 1995 of a sample of 706 Czech firms that were privatized in 1991–92 concluded that the greater the ownership concentration, the greater the improvement in profitability and market valuation. Unfortunately, this study examined a period that ended in 1992, prior to the subsequent free fall in price levels on the Prague Stock Exchange. Possibly, the higher stock market valuations at that initial stage were a transitory phenomenon that reflected the prospective control fights that were already looming.

Still, let us assume for a moment that the newly privatized firms with concentrated ownership do initially outperform comparable firms with dispersed ownership. Does this then imply that an economy characterized by concentrated ownership will be more efficient than one characterized by dispersed ownership—at least in the case of transitional economies? The problem with any such conclusion is that the benefits from concentrated ownership may prove to be short-lived, while the costs surface only at a delayed point. Even if concentrated ownership implies superior monitoring of management, these benefits have to be balanced against the enhanced risk of expropriation by controlling shareholders. Such expropriation risks the phenomenon of securities market collapse, which in turn may result in a variety of social costs. For example, in earlier noted, Polish securities markets have been able to support IPOs and other cash offerings of equity securities, while Czech markets have not. Economic growth then may be at risk.

The extent of this risk has only recently begun to emerge in new research that documents an apparent global pattern. The Asian financial crisis of 1997–98 adversely affected economic development in most emerging markets, but to varying degrees. Although most analysts have assumed that its costs lay in macroeconomic and banking policies, one provocative new study concluded that the weakness of legal institutions for corporate governance had an important effect on the extent of exchange rate depreciations and stock market declines in the Asian crisis.

Essentially, the study argues that the rate of expropriation increases when the rate of return on investment falls. In short, managers and controlling shareholders tend to steal more in bad times than in good—and investors expect this. Hence, given any adverse shock to the financial system of a region (or the world generally), the relative decline will be the worst in those countries with legal systems that confer the weakest protections to minority shareholders. Using as an example the twenty-five emerging markets that are currently open to significant capital flows (and hence are the most vulnerable to speculative attack), the study concluded that “weak enforcement of shareholder and creditor rights had first order importance in determining the extent of exchange rate depreciation in 1997–98.” Indeed, three indexes of legal institutions—which the authors termed “efficiency of the judiciary,” “corruption,” and the “rule of law”—were found to “predict the changes in exchange rates in emerging markets better than do the standard macro measures.” Other measures reflecting the strength of shareholder rights also correlated closely with the severity of the financial crisis, but with the proviso that “these measures reflect how rights are actually enforced.” To sum up, the strength of legal protections (as measured by actual enforcement practice) appeared to be the independent variable that best predicted the dependent variable of severity of financial crisis.

At this juncture, it is useful to return to the Czech experience. As noted earlier, a number of studies have found that privatized firms became more profitable to the extent that their ownership was more concentrated. But is this advantage sustainable over time? The subsequent sharp decline in prices on the Prague Stock Exchange suggests that some financial shock (from whatever source) destabilized the economy and caused a withdrawal of investor capital. Why was the market decline so severe in the absence of any major macroeconomic change in the Czech economy? Perhaps investors were aware of their potential vulnerability, but expected that managers would constrain their rate of expropriation during boom times. At the first sign of bust, however, investors race for the exits because they expect the rate of expropriation to increase.

Whether or not one accepts this premise that the rate of expropriation rises with any decline in return on investment, the critical factor in this scenario is that investor loss of confidence will be greatest in those economies in which they believe they are least protected legally. In truth, assumptions about the relationship of the rate of expropriation to the return on investment are probably unnecessary to derive this model. All that one need hypothesize is that investors will ignore legal risks and their vulnerability to expropriation by controlling shareholders during boom times, possibly on the premise that managers and shareholders will not risk disrupting the momentum that is benefiting controlling shareholders and to steal more in bad times than in good—and investors expect this. Hence, given any adverse shock to the financial system of a region (or the world generally), the relative decline will be the worst in those countries with legal systems that confer the weakest protections to minority shareholders. Using as an example the twenty-five emerging markets that are currently open to significant capital flows (and hence are the most vulnerable to speculative attack), the study concluded that “weak enforcement of shareholder and creditor rights had first order importance in determining the extent of exchange rate depreciation in 1997–98.” Indeed, three indexes of legal institutions—which the authors termed “efficiency of the judiciary,” “corruption,” and the “rule of law”—were found to “predict the changes in exchange rates in emerging markets better than do the standard macro measures.” Other measures reflecting the strength of shareholder rights also correlated closely with the severity of the financial crisis, but with the proviso that “these measures reflect how rights are actually enforced.” To sum up, the strength of legal protections (as measured by actual enforcement practice) appeared to be the independent variable that best predicted the dependent variable of severity of financial crisis.
long-term production contracts under which most of its output was effectively sold at cost (or less) to one or more shell companies. Variations on this basic pattern were numerous. For example, an entrepreneur might borrow funds to buy a controlling stake in a Czech company, using a personally owned corporation as the vehicle that borrowed the acquisition debt from a bank. Once control of the firm was acquired, the entrepreneur could merge the personally controlled firm into the privatized firm, in order to make the latter liable for the entrepreneur's personal acquisition indebtedness. As a result, the entrepreneur forces the other shareholders to bear much of the cost of the entrepreneur's acquisition of control.

Such unfair self-dealing is not particularly novel or imaginative. But, precisely for that reason, the fact that it worked so effectively in the Czech Republic suggests that there must be some characteristic weakness or vulnerability in Czech law and (because Czech corporate law was largely patterned after German law) in the civil law generally. A key reason why tunneling was successful involved the availability of legal technique through which it could be insulated from judicial scrutiny. A 1997 study by the Czech Ministry of Finance examined a variety of tactics for looting privatized companies and reported:

"Tunneling" into companies is a frequent phenomenon. Current "corporate raiders" have discovered a risk-free method of removing money from companies. This method consists of holding a general meeting of shareholders in which the "raiders" have a voting majority; this meeting grants a decision on a transaction involving corporate property... and the Board of Directors of the company then carries out this operation, with consequent damage to the company. One shareholder can blame the Board of Directors of the company for this operation as it is bound by the decision of the general meeting."

In short, if the self-dealing transaction was approved by a majority of the shareholders, the directors were effectively insulated from legal liability. Although minority shareholders could sue to challenge action taken at the shareholders' meeting, they would receive little disclosure about the terms of the transaction and hence were not in a position to raise an effective challenge.

To the extent this assessment is accurate, it reveals a sharp contrast between the constraints of Czech and those of common-law jurisdictions. For example, U.S. law, although giving considerable weight to shareholder ratification, generally does not permit a self-interested shareholder to ratify a transaction between the corporation and itself (or an affiliate). Typically, only the votes of a disinterested majority of the shareholders can have this impact. Thus, the practical consequence of this difference is to accord the majority shareholder (or shareholder...
nable to sudden collapses. Once a market becomes stigmatized, the decline is fast, not slow, because a sudden exogenous shock can cause both foreign and domestic investors to race for the exits—if they lose confidence.

To remedy these problems, some have called for the wholesale reform of corporate and securities laws in order to introduce the more protective features of Anglo-American law into the typically civil-law codes of most transitional countries. This sounds desirable, but closer analysis reveals a problem in this approach: little consensus exists about precisely what the most important and protective features of Anglo-American law are. For example, preemptive rights play an important role in the United Kingdom, but virtually no role in the United States. In contrast, class actions may generate a desirable level of deterrence in the United States, but are unknown in the United Kingdom. Although some research seems to show that common-law systems outperform civil-law systems in protecting minority shareholders, a satisfactory explanation for why this common law's apparent superiority remains elusive. Other commentators have stressed that the development of strong securities markets requires high disclosure standards and protection for minority shareholders from expropriation (both of information and property) by insiders. This seems clearly valid, but it still leaves open the considerable problem of how to get to such an ideal state from the existing starting points.

In sum, possible reforms can be grouped under three headings: (1) judicial reforms, which respond either to the underdeveloped state of the judiciary in transitional economies or to special problems relating to the alleged rigidity of the civil law; (2) structural reforms, which may require legislation but do not involve legal rules; and (3) legislative reforms, which might relate to either substantive corporate law or securities regulation. This section will begin with judicial reforms because it seems necessary to assess frankly what can and cannot be expected of the judiciary in developing countries. Thereafter, I will consider both structural reforms and possible legislative revisions.

A. Judicial Reforms

Although it is conclusive to simply assume that common-law systems necessarily offer greater protection to minority shareholders than civil-law systems, the evidence is strong that dispersed ownership persists primarily in common-law legal regimes. Potentially, this could be the result of statutory provisions that are generally found in common-law systems. However, to date, proponents of the common law's superiority have not been able to provide a convincing explanation of the critical statutory deficiencies of the civil law or the common law's features that better protect minority shareholders. Alternative hypotheses therefore need to be considered.

I. A HYPOTHESIS OF THE COMMON LAW'S ADVANTAGES

One plausible hypothesis is that the real superiority of common-law systems lies in the distinctive role of the common-law judge. A considerable law-and-economics literature views the corporate charter as a highly incomplete contract. Necessarily, there are gaps in this contract that must be filled. Law-and-economics theorists have disagreed over the years about what principle or formula the court should use in seeking to fill these gaps, but consensus exists that the common-law judge can and should fill these gaps. In contrast, the civil-law judge may not have the same authority or the same expansive understanding of the judicial role. To the extent that the civil law discredits judicial activism or views it as a usurpation of the legislature's role, the civil-law judge is confined to the narrower role of interpreting what comprehensive civil codes have actually specified. Thus, at least at the margin, the common law encourages gap filling, while the civil law tends to impede it.

Any summary description of the differences between the civil law and the common law will necessarily omit much and risks stereotyping legal systems that have considerable subtlety and variation. Nonetheless, the role of the judge does appear to be significantly different under the two systems. If it overstates the case to say that the civil-law judge is simply a bureaucrat whose job it is to interpret and apply a written body of statutes, it is still true that the civil-law judge lacks the same freedom and discretion as the common-law judge to search through a vast storehouse of legal precedents to find the rule best suited for the case before the court. By definition, the inventory of potentially applicable precedents that the common law creates confers greater discretion upon the legal decision maker.

This distinction has even greater force in the area of private law. On the one hand, civil-law codes tend to be especially comprehensive in this area and thus arguably leave room for gap filling. Conversely, the common law is more likely to leave gaps. The common law (and particularly corporate law) does not view statutes as the only (or even principal) source of law. Under the common law, legal duties can arise that are independent of any statutory source. The most important example for corporate law is the concept of fiduciary duty. Fiduciary duties can develop out of a course of dealing or a relationship involving trust and confidence where neither side has contractually assumed any duty to the other. In corporate law, the best example of how the concept of fiduciary duty invites common-law judges to fill gaps involves the duty of loyalty. Although some American states do define
the duty of care by statute, the broader duty of loyalty is generally left to the common-law process of judicial interpretation. There, it rests on a common-law foundation consisting of several centuries of judicial precedent. Even before the modern corporation arose, the law of agency and the law of trusts held the servants accountable to the master for secret profits obtained from the use of the master’s property. These decisions were later applied to hold corporate officials—including officers, directors, and controlling shareholders—to similar standards. In Delaware, the foundational decision defining the contours of this duty is Gaeb v. Left, which in broad and somewhat rhetorical prose restructures corporate fiduciaries that they are held to an “uncompromising duty of loyalty.”

Equally famous decisions in New York and elsewhere have used similarly broad language, including, of course, Justice (then Judge) Benjamin Cardozo’s famous phrase that a fiduciary must observe not merely the “morals of the marketplace . . . but the punctilio of an honor the most sensitive.” Sophisticated judges today recognize that such broad norms must be applied in a context-specific fashion, and this may lead them to deemphasize the rhetorical flourishes of an earlier generation and instead consider the hypothetical bargain into which shareholders and corporate fiduciaries have entered. But attempts to “contract out” from the duty of loyalty through broad exculpatory charter provisions have generally failed.

The immediately relevant point is that the common law’s concept of fiduciary duty both enables and instructs the common-law judge to fill in the gaps in an incomplete contract. Indeed, the fiduciary concept both tells the courts what implied and noncancelable conditions must be read into the corporate contract and provides a rich repository of illustrations in the form of cases to guide the court. No similar deep inventory of legal precedents existing apart from the statutory law of the corporations code arms the civil-law judge. To be sure, some modest steps toward recognizing a fiduciary duty to minority shareholders have been taken in some civil-law jurisdictions (most notably, Germany), but the concept has been stated only in the abstract and lacks any effective enforcement mechanism. As a result, although the differences between the civil law and the common law can easily be overstated, the civil law essentially views the corporations code as the law and confines the judge to, more or less, mechanically applying it, while for the common-law judge, corporate law is a complex amalgam of statutes and judicial decisions. Rather than replacing or superseding earlier judicial precedents, the statutory corporations code can be seen as attempting to codify those precedents.

This hypothesis that the common law tends to encourage gap filling, while the civil law discourages it, certainly remains open to challenge.

Some empirical evidence finds British judges, for example, to be less “daring” than their civil-law counterparts in France or Germany. But whatever the overall level of caution of British judges, the context of corporate law may be distinctive. There, the concept of fiduciary duty— with its clear statement that there exists a legal duty, independent of statute or contract, to be fair to minority shareholders—invites and provokes courts to fill in apparent gaps in the corporate contract. Still, even if the common law does better arm the judge to resist opportunism, what relevance does this contrast have for transitional economies? That is, even if common-law judges have greater discretion and can fashion novel remedies, it does not follow that their style of judicial behavior can be imposed on civil-law juridicities. It is simply not a feasible reform to attempt to convert civil-law judges into common-law judges (it would be easier to convert financial economists into law professors, or vice versa). But such pervasive reforms may not be needed, because only a small portion of the workload of most judges in either system will deal with corporate or securities-law matters. The simpler course may be simply to transfer this portion of their caseload to a specialized tribunal, as discussed next.

2. SPECIALIZED COURTS

The inflexibility of civil-law courts has already led in some countries to the creation of specialized courts, which have exclusive jurisdiction over some subject matters. One example is the German experience with labor-law courts, which were created because labor law inherently requires a difficult style of decision making. Indeed, even common-law countries have made substantial use of specialized tribunals to hear securities-law disputes. For example, the federal securities laws now also contemplate their enforcement before administrative law judges.

Thus, a practical approach to effective enforcement may lie in creating a cadre of administrative judges within an SEC-like agency, authorized to broadly enforce both disclosure obligations and certain rules against self-dealing (such as the insider-trading prohibition). Such judges would be trained within the agency and empowered to impose substantial civil penalties. Their jurisdiction could be limited to enforcement cases brought by the agency, or it could be expanded to include suits by investors for restitution. Although these judges would presumably lack criminal-law jurisdiction, they could be authorized to grant bar orders that could effectively suspend or disbar an individual or entity from the functional activity of being a broker, investment adviser, accountant, or attorney, or from having any association with any entity that engaged in these activities. As a further backstop, persons who knowingly engaged in such specified activities with such a defen-
trol that characterized the Czech experience—at least until the legal and regulatory structure has gained some experience with privatization; (2) they may constitute more active monitors than private investment funds—at a minimum, they can at least be charged with the mission of developing a restructuring plan for their portfolio companies; and (3) they serve as a means of aggregating individual shareholders and thus partially solving collective action problems.

Ultimately, however, true privatization requires that the NIF wither away—or else firms would still remain under indirect state control. Thus, a strategy for a phased downsizing of the NIF is necessary. Here, the Polish model was incomplete because it gave the NIFs a ten-year life, but did not provide for the gradual shrinkage of their controlling blocks. A subtler approach might have been to reduce the NIFs' stakes from the 33 percent starting point on an annual basis, that is, down to 30 percent after year 1, 25 percent after year 2, 20 percent after year 3, and so on. In addition, it might be wise to stagger this schedule so that some NIFs downsized and disappeared faster than others—thereby creating a natural experiment and permitting legislative or regulatory reforms if the first generation of NIFs to disappear gave rise to a series of scandals. Such a phased reduction makes more sense than simply turning the NIFs over to private owners at a single stroke, because that approach invites the same rent-seeking struggle for control as occurred with the Czech funds.

Another attraction of this approach is that it should encourage foreign portfolio investors (who will not seek control and know they cannot actually manage portfolio companies) to remain active in the equity market and possibly become a monitoring substitute that over time could collectively replace the state-created NIFs. In contrast, a scramble for control in which the winner acquires a significant control premium may cause foreign portfolio investors to flee the market because they cannot compete. Still, the overriding attraction of this approach is that it is "self-enforcing" and does not require judicial implementation in order to discourage rent-seeking control contests.122

2. STOCK EXCHANGE LISTING STANDARDS

Long before there was an SEC in the United States, the New York Stock Exchange and the London Stock Exchange had succeeded in winning investor confidence. They did so by imposing relatively rigorous disclosure and listing standards and transparency requirements that exceeded those prevailing in other markets. Exchanges do not have ideal incentives, however, for the task of enforcement. Because they profit on trading volume, and they compete to list companies, they will not wish to delist an actively traded company, even when it misbehaves badly.
Similarly, their incentives to take enforcement action against powerful broker-dealers may also be suboptimal. For these reasons, at least in a transitional economy, the control over listing standards may better belong to a government agency.

Here, the contrast between the Czech and Polish experiences is particularly instructive. As of late 1998, only 253 companies traded on the Warsaw Stock Exchange, while some 1,716 firms traded in the Czech market in 1995—a nearly 7:1 ratio, despite the fact that the Polish economy dwarfs that of the considerably smaller Czech Republic. Eventually, the Prague Stock Exchange was forced to delist more than 75 percent of its companies, both to maintain its credibility and to satisfy Czech regulators.124

Of course, if exchange trading is restricted, substitutes will develop, including formalized over-the-counter markets. Such markets may be risky and characterized by dubious offerings and market practices. So be it. Their potential failure should not jeopardize the higher-quality market. Indeed, markets may naturally self-aggregate into high-quality and lesser-quality markets. In times of economic stress, the lower-quality market should incur the greater decline.

Such a pattern would permit significant privatization without exposing the principal securities market to the same risk of a Czech-style collapse. Enforcement resources might also be concentrated on the higher-quality market to maintain its reputational integrity. One goal of this effort would be to convince foreign portfolio investors that the higher-quality market would be treated and to encourage their investment in it.

1. THE OPTIMAL MONITOR

The Polish and Czech experiences represent polar extremes. Essentially, the Czech privatization process relied on highly entrepreneurial, but legally unconstrained, monitors in the form of investment funds that more or less spontaneously arose. In contrast, the Polish approach was to rely upon highly constrained, state-created NIFs, whose entrepreneurial skills and incentives remain unproven. Neither choice seems optimal (at least by itself). There is, however, a third, obvious candidate: the existing foreign portfolio investor. Not only do foreign institutional investors have relatively scandal-free histories (and reputations that they wish to preserve), but there is evidence that they resolve superior monitors. In one recent study, two Harvard Business School researchers examined data from Iolita during the 1990s and concluded that foreign institutional investors significantly outperform domestic financial institutions as corporate monitors.125 Domestic financial institutions, they found, had insufficient incentives or skills to monitor management or play any effective role in corporate governance. In contrast, foreign

institutional ownership proved to be positively correlated with positive changes in Tobin’s Q (while domestic financial ownership was actually negatively correlated with such changes).126 Such a finding that domestic financial institutions play only a modest monitoring role (and may have conflicted motives) is essentially consistent with the Czech experience and with similar findings about Russian privatization.127

Equally important, the authors found that foreign institutional investment only occurs under circumstances of high transparency (for example, institutions tend to avoid investment in affiliated business group). Hence, a stock exchange with rigorous listing requirements and high transparency seems likely to attract the most effective and experienced corporate monitors. In turn, as stock exchange listing is seen to attract foreign equity capital, the willingness of other companies to list and accept meaningful listing conditions may increase. To be sure, this strategy has its limitations: small capitalization corporations and small market countries tend to be ignored by institutional investors. But that is no reason to reject a partial answer.

More can, of course, be done to attract foreign investors. While the use of voucher privatization was politically necessary at the outset of privatization for a variety of reasons, contemporary sales of the remaining state-owned shares in partially privatized enterprises might be made through auction sales to which foreign institutional investors were specifically invited.

C. Legislative Reform

The Czech experience with tunneling does suggest that at least the German civil-law system of corporate governance unnecessarily exposes minority shareholders to risks of expropriation. The key problems center around disclosure and enforcement.

1. OVERVIEW

Because concentrated ownership systems of corporate governance have few companies in which a majority of the shares are held by public (i.e., non-controlling) shareholders, their legal rules have understandably focused on protecting the minority shareholder from the controlling shareholder, not from management. Management, it is assumed, can be controlled by the supervisory board or by powerful shareholders. Hence, German law does not authorize an American-style derivative action in which a small shareholder can cause the company to sue management. This role is instead given to the supervisory board.

But privatization inherently creates publicly held companies with dispersed ownership, and hence gives rise to the danger of managerial
expatriation because there are not necessarily any large shareholders to monitor management at the outset. In short, there is a fundamental mismatch: a system of legal rules designed to deal with concentrated ownership works less well when confronted with the new phenomenon of dispersed ownership.

2. DISCLOSURE

German law does provide that a managing director is liable if the director intentionally or negligently fails to prevent the corporation from doing business to its disadvantage with a company affiliated with the director.128 But German law does not obligate the director to disclose to the shareholders any personal financial interest that the director has in a proposed transaction.129 Even when disclosure is required (as in the case of transactions between parent corporations and their majority-owned subsidiaries within a Konzern, or affiliated group), disclosure must only be given to the supervisory board, not the shareholders. This makes it easy to see largely academic if shareholders lack the knowledge that will cause them to raise objections. This critique is by no means new and has long been raised by German academics themselves.130 Yet even if disclosure were required (as surely it should be), and even if a derivative action were permitted, it might have little impact unless American-style contingent fees were permitted. This seems unlikely, given the shock that civil lawyers express at such a system. As discussed below, disclosure to shareholders should be required, and might be enforced through listing standards.

3. SELF-DEALING; LISTING STANDARDS VERSUS PROPHYLACTIC RULES

A consensus seems to exist that it is unrealistic to place high expectations on either the judiciary or independent directors in transitional economies.131 Judges are likely to enforce satisfactorily only bright-line rules. Thus, it seems ill advised to make proof of intent or purpose or bad faith necessary elements of any cause of action because this increases the unpredictability of results. But this premise leads to two immediate problems: (1) U.S. and U.K. law do not bar self-dealing transactions, but rather subject them to a variety of highly nuanced standards, and (2) in many transitional economies, affiliated business groups are the norm, meaning that intracorporate transactions within such affiliated groups will be common. Yet such transactions can often be used to appropriate wealth from minority investors.

This dilemma could be addressed in a number of ways. Corporate law could simply preclude self-dealing (or make it so legally uncertain as to place a prohibitive penalty on it). This was essentially what U.S. law did as of the late nineteenth century, when the United States was itself a transitional economy.132 Potentially, such a prophylactic rule would last only for the time it took the transitional economy to mature (which is again the U.S. experience). For this approach might require disassembling of all affiliated groups, and this could be economically disruptive and politically impractical.

The other, more feasible alternative would be to superimpose listing standards that kept members of affiliated business groups off the "high quality" exchange, at least if their inter-corporate transactions reduced transparency. This would place a considerable cost on self-dealing (by denying members of affiliated groups easy access to the equity markets), but the cost is probably not prohibitive. Those firms that truly found membership in an affiliated group to be efficient could probably still obtain equity capital from the over-the-counter market. More important, this option forces a firm to choose between a "dispersed ownership" versus a "co-concentrated ownership" governance system, and it signals to institutional investors that a high-quality equity market is intended to accommodate only firms that elect to comply with the rules of the former system.

Supplementing this prohibition on listing members of an affiliated business group (other than the sole parent) would be listing rules excluding defined self-dealing transactions by management, controlling shareholders, or other insiders. Such rules would, of course, focus only on (1) transactions that were material to shareholders (excluding, for example, ordinary compensation), and (2) transactions that could be easily monitored (for example, purchases and sales of corporate divisions or significant corporate assets by persons affiliated with management).

Some low-visibility transactions would escape the scope of these rules, and some violations would inevitably escape detection. But if the enforcement of such rules were delegated to the jurisdiction's securities commission (rather than the exchange itself), this system could be implemented with respect to the largest and most important corporations in the jurisdiction—without relying on costly and uncertain litigation. Over time, such a system could create its own culture of compliance, with smaller firms seeking to elect in as they matured. In effect, entry into the high-quality market would constitute a bonding device by which firms could assure investors of fair treatment and thereby lower their cost of equity capital.

4. CONTROL ACQUISITION

Following repeated scandals in the Czech securities market, reform legislation was adopted in 1990 that essentially introduced a key element of the British corporate governance system, namely, no person could cross a defined ownership threshold, except by making a tender
least partially present in Poland, but were originally absent from the Czech Republic.

More generally, privatization has produced a conceptual mismatch. Inherently, it produces an initially dispersed ownership, but under a legal regime intended to accommodate concentrated ownership. The result is necessarily short-lived. In this light, the critique advanced by new proponents of comparative corporate governance that civil-law systems fail to provide adequate minority protection needs to be reformulated.\textsuperscript{116} Civil-law systems may well protect minority shareholders against the forms of abuse long known in systems of concentrated ownership (most typically, dominance by a controlling shareholder). But civil-law systems do not address abuses that they have not witnessed (such as the theft of the control premium in an exploitative partial takeover). Hence, they leave public shareholders in a system of dispersed ownership exposed to a winner-take-all scramble for control, in which the losers can expect future expropriation by the winners. Privatization, of course, creates just such a system of dispersed ownership vulnerable to this form of abuse.

More generally, the voting, proxy, and disclosure systems under the German civil-law approach do not contemplate that small shareholders will play any active role. This premise may be valid in their environment, but when this system is applied to privatized companies, it leaves small shareholders powerless and thus helps to compel a transition to concentrated ownership. Rather than seeing this transition as inevitable, policy planners must recognize that it is a contextual product of the dominant forces in the legal and market environment. Phrased more generally, because civil-law systems of corporate governance implicitly contemplate concentrated ownership, they have disadvantages disclosure to the market in favor of disclosure to the supervisory board. In consequence, the civil law tends to inhibit the development of securities markets, whose growth depends upon the breaking down of informational asymmetries.

Whether differences in judicial style and performance between common-law and civil-law systems matter significantly in the success of privatization and the stability of dispersed ownership seems more debatable. One problem with any such comparison is that the presumed homogeneity of common-law systems also seems suspect. The United States and the United Kingdom have achieved functional convergence, but not formal convergence. The effective absence in the United Kingdom of litigious remedies that are available to minority shareholders suggests that the combination of high-disclosure standards and an active, unconstrained takeover market may constitute an effective functional substitute for litigation (as other remedies that are more available in the United States). Legally, as much may separate the United States and the United Kingdom as unites them.

To the extent that one is skeptical of the ability of the judiciary in transitional economies to restrain opportunism, the natural policy response may be to recommend reliance on "self-enforcing" remedies.\textsuperscript{117} Indeed, the Polish NIFs may supply the best feasible example of such a structural reform. Nonetheless, the idea that "self-enforcing" remedies would prove sufficient by themselves has been shown to be overconfident. The primary problem is that viable securities markets will not develop as persist in the absence of some workable mechanism of regulatory enforcement. Fraud, manipulation, insider trading—these practices become endemic in the Czech Republic (for at least a period of time) under a legal system that was as laissez-faire oriented as it existed anywhere in recent times. To develop liquid markets, regulation must overwhelm these practices that will otherwise drive portfolio investors from the market. This does not necessarily mean that U.S.-style class actions are necessary or that common-law judges must be imported into civil-law jurisdictions (nor do such reforms seem feasible), but it does suggest that other enforcement techniques, such as specialized courts and administrative enforcement proceedings, need to be seriously explored.

Academic attitudes are changing. Whereas not long ago concentrated ownership was seen as efficient and dispersed ownership was taken by some to imply overregulation of institutional investors, concentrated ownership is now being viewed by others as a measure of weak protection for minority shareholders. Predictably, academic fashions will change again, but the critical issue is an applied one: how to establish strong securities markets? Here the data from the aftermath of the Asian financial crisis suggests that minority protection appears to be a necessary, but not a sufficient, condition to the emergence of viable securities markets.\textsuperscript{118}

The bottom line, as usual, is that those ignorant of history are destined to repeat it. "Fast" privatization unaccompanied by minority protection and adequate disclosure standards will produce expropriation and rent-seeking. To call this outcome inevitable, however, is only to claim that ignorance is inevitable.
reciprocate at the Michigan conference, including in particular his commentators, Professors Andrew Weiss of Boston University and Ken Lehn of the University of Pennsylvania. Noise bears any necessary responsibility, however, for the views expressed herein. All rights reserved by the author. Copyright John C. Coffee, Jr. 1999.

1. This reference is to a quotation from a now obscure nineteenth-century economist, Karl Marx, who coined the phrase in 1848. See Karl Marx & Friedrich Engels, Manifesto of the Communist Party (1948) (observing that the specter of communism was haunting Europe). Younger scholars are not expected to be familiar with this material.

2. The principal efforts have been by four financial economists, writing jointly, cited by some as the "Gang of Four," but hereafter referred to more neutrally as "LLS,sV." See, e.g., Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, Corporate Ownership around the World, 54 J. Fin. 471 (1999); La Porta, Lopez-de-Silanes, Shleifer, & Robert Vishny, Law and Finance, 106 J. Pol. Econ. 1113 (1998); La Porta, Lopez-de-Silanes, Shleifer, & Vishny, Legal Determinants of External Finance, 52 J. Fin. 1111 (1997). For another provocative effort in this same vein, see Simon Johnson et al., Corporate Governance in the Asian Financial Crisis, 1997-1998 (Jan. 1999) (working paper, on file with author).

3. For the latest commentary by LLS,sV on this theme, see La Porta, Lopez-de-Silanes, Shleifer, & Vishny, Investor Protection and Corporate Governance (June 1999) (working paper, on file with author).

4. See sources cited supra notes 2 and 3. Although these systems may seem static, individual firms can migrate from one to the other, principally by locating on a stock exchange in a "dispersed ownership" nation. I have suggested elsewhere that such migration would in the long run necessitate a displacement of the traditional concentrated ownership system. See John C. Coffee, Jr., The Future as History: The Prognosis for Global Convergence in Corporate Governance and Its Implications, 93 Nw. U. L. Rev. 641 (1999).

5. Financial economics, as a field, has long been skeptical of regulacism. For an indication that this attitude is changing, see, e.g., Simon Johnson & Andrei Shleifer, Cost v. The Countries: The Regulation and Development of Securities Markets in Poland and the Czech Republic (Sept. 1999) (working paper on file with author).

6. This possibility was first implicitly noted in Coffee, supra note 5, and has been explicitly advanced in convincing detail by Katharina Piiper. See Katharina Piiper, Law as a Determinant for Equity Market Development: The Experience of Transition Economies (Mar. 1999) (working paper, on file with author).


8. It is ironic, however, that the arguments are very similar to those advanced by Judge Easterbrook and Fischel. See supra note 7.


10. Id.

11. For such well-known efforts, see Jonathan Macey & Geoffrey Miller, Toward An Interest-Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469 (1987).

12. Neoclassical economic theory views the firm as a "means of contracts." See Jensen & Meckling, supra note 9, at 110-11. Yet privatization often short-circuits this contracting process by simply creating a dispersed shareholder base. A stable equilibrium is thus not reached. The result is that the shareholders have less well defined legal rights and are more vulnerable to opportunistic actions by those in control.

13. For examples of this new critique of "fast" privatization, see John Nellis, Time as a Related Proportion in Transactional Economics: Fin. & Dev. June 1999, at 16, 16-.-


15. See sources cited supra notes 2 and 3. LLS,sV run regression analyses that rank the minority protections given shareholders in different countries in terms of the presence (or absence) of certain specified statutory protections and then correlate these rankings to the size of each country's securities markets. While they find a strong relationship between weak protections and weak markets, such studies remain vulnerable to the problem of multicollinearity (that is, the true predictive variable may escape detection because it was not included in the sample but overlapped with the independent variable that seems to show predictive power). For example, a statutory provision that limits ex post predictive power may overlap with a softer and more lenient factor (such as a strong and independent judiciary). Necessarily, em- piricians measure the data that is available, and in the case of "softer" variables (such as judicial style and judicial independence), little data is available. Hence, these softer variables may be ignored.


17. See Klein, supra note 17, at 80-86.


19. There is already some empirical support for this modest revision of the LLS,sV thesis. See infra notes 87-90 and accompanying text.

20. For example, the foreign (and largely institutional) shareholders of Far Eastern Shipping Company, Russia's largest commercial shipping line, have proposed that the provincial governor of Vladivostok object to their large ownership stake (42 percent) in Far Eastern and demanded that they surrender 7 percent of their shares to him. Otherwise, he allegedly threatened to reduce their voting rights by provincial decree. See Nelli Bagger, Shareholders Charge Extortion in Russian Far East, N.Y. Times, June 16, 1999, at C1. For a discussion of other instances in which
Privatization and Corporate Governance • 307

32. Green, supra note 30, at 16. Specifically, the PX-50 index fell from 1,000 to 371.
33. Id.
35. Czech GDP contracted by more than 2.5 percent in 1998 (whereas neighboring countries experienced a 4–5 percent annual growth). See Neffs, supra note 13, at 16–19.
36. Green, supra note 30.
37. I have discussed the contrasting experiences of these two nations at greater length elsewhere. See John C. Coffee, Jr., Becoming a Corporate Manager for Transnational Economic: The Uncertain Lessons from the Czech and Polish Experiences, in Comparative Corporate Governance: The State of the Art and Emerging Research 67, 122–23 (Klaas J. Hopt et al. eds., 1998).
38. See Sari Eerin et al., The Impact of Privatization Funds on Corporate Governance in Mass Privatization Scheme: The Czech Republic, Poland and Slovenia, in The Governance of Privatization Funds: Experiences of the Czech Republic, Poland, and Slovenia 117, 142 (Marko Simonen et al. eds., 1999).
39. For a detailed description of the NIF, which essentially resembled closed-end mutual funds and were created by the Polish Ministry of State Treasury to hold controlling stakes in privatized firms, see Janusz Lewandowski & Roman Szwarc, The Governance of Privatization Funds in Poland, in The Governance of Privatization Funds, supra note 36.
41. According to Thiel, only 3 percent of actual trades were executed on the Prague Stock Exchange. See Thiel, supra note 40, at 111. In part, this was attributable to the existence of a Nassyak-like alternative system, which also disclosed prices contemporaneously. Still, investment funds could trade on a face-to-face basis off the exchange and use the exchange only for transactions at inflated prices.
42. Emerging markets appear in general to have very different characteristics from mature, efficient markets. In particular, stocks in emerging markets exhibit strong "mismatching," meaning that one period's performance tends to predict the next period's performance; also, high beta stocks do not outperform low beta stocks. See K. Greer Roosevelt, Local Return Factors and Turnover in Emerging Markets, 54 J. Fin. 1439, 1441 (1999).
43. Of the thirteen largest investment funds in the first wave of Czech privatization, eleven were created by financial institutions. See Eerin et al., supra note 38, at 151. This was probably predictable, because citizens were already familiar with the local savings, commercial, or postal banks that sponsored these funds.
44. Other motivations can also explain this failure to concentrate holdings (which continued in secondary market trading as well as in the original privatization auctions). For example, in nontransparent markets, trading in the stocks of newly privatized firms may be highly profitable for informed traders with access to the boards of their portfolio companies.
60. See Coffee, supra note 5, at 673–76 (discussing foreign listings as a bonding mechanism). 61. See Coffee, supra note 7, at 45. 62. Id. at 46. 63. Data showing these discounts as of the fall of 1999 has been provided to me by Professor Andrew Weiss, an economist at Boston University. He informs me that, as of late September, 1999, the average discount on the Polish NIFs relative to their net asset value had grown to 60 percent, which was as great or greater than the standard discount on Czech funds earlier in the decade. 64. Professor Weiss points to the example of the Restitution Fund, which is the largest Czech fund and which now trades at 1,500 (of late September 1999) and has a net asset value of 1,250 (or less than a 20 percent discount). In 1994, it traded for between 500 and 600. Another example is SPPF Cesky, which now trades at 1,346 and was trading at 496 in December, 1994. One possible reason for this resurgence may have been reform legislation, which was adopted in 1998. Pursuant to this legislation, many Czech funds converted to a basically open-end status. Open-end funds do not, of course, have the same discount as a closed-end fund because their shares can be redeemed. 65. See Piotr, supra note 7, at 49. 66. For a closer assessment of the similarities and differences in Czech and Polish corporate law during the period, see Piotr, supra note 7, at 35–44. Piotr notes that the Czech Republic did have a considerably lower quantum requirement (30 percent), which may have facilitated some fraud, and a higher (and hence less protective) mandatory bid requirement, but overall he finds that both countries provided only weak protections in their corporate law for minority shareholders. 67. See id. at 17–18. 68. Id. at 37 (noting that Polish law has required ownership disclosure at the 10 percent and 25 percent levels). Section 1(b) of the Securities Exchange Act of 1934 requires shareholders of a “reporting company” to disclose to both the issuer and the SEC their identity, sources of financing, plans and intentions, and certain other information when—they alone or as a part of a group—they acquire more than 5 percent of any class of equity security of such an issuer. Securities and Exchange Act of 1934 § 1(b), 15 U.S.C. § 78c(d) (1994). 69. Poland adopted a 35 percent threshold (originally, it was 50 percent), while the Czech Republic introduced this reform (but only at the 50 percent level) only more recently. Piotr, supra note 7, at 17–18. 70. Id. 71. See sources cited supra notes 2 and 3. 72. Lucian Bebchuk has theorized that these competitive struggles for a control ling position are predictable whenever the private benefits of control are large and control is not locked up by special charter provisions. See Lucian A. Bebchuk, A Rent-Protection Theory of Corporate Ownership and Control (Nat’l Bureau of Econ. Research, Working Paper No. 7201, 1999). These conditions would seem usually to be satisfied when voucher privatization is used in a transitional economy, because it exposes control to acquisition and the private benefits of control are necessarily high when judicial controls are undeveloped. 73. See supra notes 55–56 and accompanying text.
74. See supra notes 63–65 and accompanying text.
75. For a fuller description of these offerings, see William Megginson et al., The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis, 99 J. Fin. 406, 406 (1994). An arguably similar trade in Volkswagen continues to be held by one German state (Lower Saxony).
76. Id. at 407.
78. For an overview of Mexican privatization, see Rafael La Porta & Florence Lopez-de-Silanes, Benefits of Privatization: Evidence from Mexico, Private Sector, at 21–24 (World Bank, June 1997).
79. For recent detailed accounts, see Fox & Helleur, supra note 19, Bernard Black et al., Russian Privatization and Corporate Governance: What Went Wrong? (Sept. 1999) (unpublished manuscript, on file with author).
80. See Joseph Blasi & Andrei Shleifer, Corporate Governance in Russia: An Initial Look, in Corporate Governance in Central Europe and Russia (Roman Frydman et al., eds., 1996).
81. See supra note 19 and accompanying text.
82. See Black et al., supra note 79.
86. See supra notes 55–56 and accompanying text.
87. Johnson et al., supra note 2, at 3.
88. Id. at 4.
89. Id. at 5.
90. Id.
91. See supra notes 84–85 and accompanying text.
93. Id. at 283.
94. Aggarwal and Angel in fact give greater weight in their account to an adverse selection perspective than to the "good firms" measure from the ECM to the Amex, while "bad" firms remained behind. Id. at 261.
95. Aggarwal and Angel observe: "During the 1980s, virtually every stock market in Europe established a special section for companies that were too small to meet the normal listing requirements. ... Many of these markets appeared to prosper for a short time, but ultimately they all suffered from severe illiquidity and attracted few companies or investors." Id. at 281. Amsterdam closed its Official Parallel Market in 1993, and London closed its Unlisted Securities Market in 1996. Id.
96. For these and other examples, see, Coffee, supra note 37, at 113–14.
97. See Czech Ministry of Finance, supra note 54.
98. Some U.S. states specifically prohibit the votes of interested shareholders in establishing the procedures by which a conflict of interest transaction may be approved by the board or shareholders as a way to overcome the presumption against exculpatory self-dealing. See, e.g., Cal. Corp. Code § 140 (West 1996). Others, including Delaware, have reached a similar result by judicial decision. See Fieger v. Lawrence, 161 A.2d 218, 222 (Del. 1967) (shareholder approval merely removes "cloud and does not unlock fornerness.
99. For a brief overview, relating the application of this law to traditional economies, see Gourio, supra note 7, at 17–18.
101. See Petter, supra note 7, at 55–44. These techniques were in fact used in practice by one notorious Czech entrepreneur. See Charles Wallace, The Piratas of Prague, Fortune, Dec. 23, 1996, at 78 (discussing the career of Victor Kresty); Coffet, supra note 37, at 112.
102. See La Porta et al., Corporate Ownership Around the World, supra note 2, at 105 (in 73 percent of cases, no other large shareholder exists when there is a controlling shareholder).
103. See Black & Coffee, supra note 23 at 207.
104. See sources cited supra notes 2 and 3.
106. Japan in the marginal case because it has dispersed ownership (along with a unique control structure). It is primarily a civil-law country, but with American securities laws imposed in the aftermath of World War II. This pattern may suggest that securities laws are more important than common-law remedies, or it may just be that Japan has developed unique institutions by which to preserve investor confidence.
107. For standard statements of this perspective, see Easterbrook & Fischel, supra note 8, at 1–19; see also Jonathan H. Macey, Corporate Law and Corporate Governance: A Contractual Perspective, 18 J. Corp. L. 181 (1993).

111. The law of insider trading has shown how complex this issue can be when a fiduciary duty arises, but the key criteria are (1) the party to be charged with the duty, and (2) dependence by the beneficiary. See, e.g., United States v. Christman, 947 F.2d 551, 569 (2d Cir. 1991).

112. 23 Del. Ch. 215, 5 A.2d 503, 510(Del. 1939).

113. Id. at 510–11.


116. The German Federal Supreme Court recognized that controlling shareholders owe a fiduciary duty of loyalty to minority shareholders in the much-discussed "Linzener Case" in early 1988. See Entscheidungen des Bundesarbeitsgerichts in Zivilsachen [BGer 2] [second court] 103, 184 (B.R.G.). See generally, Hwa-Jin Kim, Markets, Financial Institutions, and Corporate Perspectives from Germany, 35 Law & Pol'y Int'l Bus. Rev. 171, 192–94 (1995). In addition, Germany has a separate body of law called "Kostentil law" which is intended to protect both minority shareholders in, and creditors of, companies that belong to a group of companies. See also assumptions, supra note 500. See generally, J. Bernt Bovin, The Process of Minority Shareholders in a Konzern under German and United States Law, 18 Harv. Int'l L.J. 151 (1977).

117. Whatever the situation in Germany, for fewer rights (or remedies) that can be exercised by minority shareholders seem to be recognized elsewhere on the continent. See Jonathan R. Masny, Italian Corporate Governance: One American's Perceptions, 19 Colum. Bus. L. Rev. 1, 29–35.

118. See Cooker & Ginsburg, supra note 22, at 300–303.

119. Ibid. Russia has experimented with an "economic court" system, but with mixed results at best. See Karen Halverson, Resolving Economic Disputes in Russia's Market Economy, 18 Mich. J. Int'l L. 39 (1996). In contrast to an independent economic court, the proposal here is made for a specialized court that is located within the agency in whose law the court is to specialize.

120. German labor courts date back to the Weimar Republic and were designed to "force labor-management disputes into a procedural framework similar to the private process of party competition and parliamentary decision making." See Erhard Blumberg, Patterns of Legal Culture: The Netherlands Compared to Neighboring Germany, 46 Am. J. Comp. L. 1, 26 (1998). The German labor courts now have ten divisions at the federal level and twenty-seven judges at this level alone. Id. at 17.

121. As a result of recent legislative sections, Section 248 of the Securities Exchange Act of 1934 now authorizes civil penalties in administrative proceedings in amounts up to $500,000 in egregious cases. Similarly, Section 21C of the same statute authorizes the SEC to impose administrative "cease and desist" orders—in effect, a type of civil injunction. Thus, even in the United States where judicial remedies are probably most available and most flexible, securities regulators believe it important to bring at least some remedies "in-house" where they would be litigated before administrative law judges trained at the agency and exclusively involved with securities law enforcement.

122. In civil-law countries, there is no right to a jury trial, which is the factor probably most responsible for limiting the jurisdiction of administrative law judges in civil cases in the United States.

123. I use self-enforcement here in the same sense as that in which was originally used by Professors Black and Krasman to mean a remedy of protection that did not require judicial enforcement to be effective. See Black & Krasman, supra note 17.

124. See supra notes 30, 52, and accompanying text.

125. See Piotr, supra note 7, at 19 (1996) (citing Czech firms delisted under pressure from regulators).


127. Id at 19. Tilam's Q is a well-recognized financial measure that consists of the ratio of the firm's market value to the replacement cost of its assets. A low Tilam's Q (which arises if the replacement cost exceeds or approaches the firm's market value) is seen as indicating poor managerial performance. See, e.g., Henri Servaes, Tilam's Q and the Costs of Taking, 40 J. Fin. 609, 619 (1995).


129. I rely here on the analysis of Professor Theodor Baums of the University of Osnabruck for this proposition, who cites me to Section 99 of the German Stock Corporation Act.

130. I again rely on Professor Baums for this statement. See also Ekkhard Wanger & Christoph Kaisers, The German System of Corporate Governance—a Model That Should Never Be Imitated? 27–29 (working paper, on file with author) (discussing the absence of disclosure obligations under German corporate law and weakness of German proxy system).

131. See supra notes 100, 116, and accompanying text.

132. For a strong and sensible statement of this view, see Black & Krasman, supra note 17, at 21–27.

133. The shifting attitude of U.S. law and the progression from flat prohibition of fiduciary self-dealing to greater tolerance is described in Harold Marsi, Jr., The Director's Trustworthiness: Conflicts of Interest and Corporate Morality, 22 Bus. Law. 35 (1966).

134. Poland uses a 33 percent ceiling, which is a more meaningful definition of actual de facto control, also, that level corresponded to the amount assigned to the lead NIF in each privatized utility. See Piotr, supra note 7, at 37–38.

135. Ironically, the Czech law already limited any investment privatization fund to a 20 percent ownership of the equity securities of any firm. See Coffin, supra note 37, at 121–22. But these rules were easily evaded, either by using multiple funds or by the agents of investment manager or, ultimately, by deregistering as a fund and becoming an unregulated holding company.

136. See André Shleifer & Robert Vishny, Large Shareholders and Corporate Control, 94 J. Fed. Econ. 461 (1988) (filing firm value in U.S. firms, is maximized when there is a large but noncontrolling shareholder).
CHAPTER EIGHT

The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements?

Randall Morck, Bernard Young, and Wayne Yeung

Stock prices move together more in poor economies than in rich ones. This is not a result of market size and is only partially explained by higher fundamentals correlation in low-income economies. However, measures of property rights do explain this difference. The systematic component of returns variation is large in emerging markets and appears unrelated to fundamentals or movement, consistent with noise trader risk. Among developed economy stock markets, higher firm-specific returns variation is associated with stronger public-investor property rights. We propose that strong property rights promote informed risk arbitrage, which capitalizes detailed firm-specific information.

I. Introduction

Stock returns reflect new market-level and firm-level information. As Richard Roll makes clear, the extent to which stocks move together depends on the relative amounts of firm-level and market-level information capitalized into stock prices.1 We find that stock prices in economies with high per capita gross domestic product (GDP) move in a relatively unsynchronized manner. In contrast, stock prices in low per capita GDP economies tend to move up or down together. A time series of stock price synchronicity for the U.S. market also shows that the degree of comovement in U.S. stock prices has declined, more or less steadily, during the twentieth century. These findings are not the result of differences in market size or economy size.2

We consider three plausible explanations for our finding. First, firms in low-income countries might have more correlated fundamentals, and the correlation might make their stock prices move more synchronously. For example, if low-income countries tend to be unserviced, firm-level earnings may be highly correlated because industry events are ex-