Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the U.S., and the EU

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Abstract

Countries pursuing economic development confront a fundamental obstacle. Reforms that increase the size of the overall pie are blocked by powerful interests that are threatened by the growth-inducing changes. This problem is conspicuous in efforts to create effective capital markets to support economic growth. Controlling owners and managers of established firms successfully oppose corporate governance reforms that would improve investor protection and promote capital market development. In this article, we examine the promise of *regulatory dualism* as a strategy to diffuse the tension between future growth and the current distribution of wealth and power. Regulatory dualism seeks to mitigate political opposition to reforms by permitting the existing business elite to be governed by the old regime, while allowing other firms to be regulated by a new parallel regime that is more efficient. Regulatory dualism goes beyond similar but simpler strategies, such as grandfathering and statutory menus, by incorporating a dynamic element that is key to its effectiveness, but that requires a sophisticated approach to implementation.

A paradigmatic example of regulatory dualism is offered by Brazil's "New Market" (*Novo Mercado*), a voluntary premium segment within the São Paulo Stock Exchange that allows companies to commit credibly to significant protection of minority shareholders without imposing reform on companies controlled by the established elite. Yet regulatory dualism as a strategy for capital market reform is not unique to Brazil, nor is it suited just to developing countries. The long-standing U.S. approach to state-level corporate chartering is arguably better understood as a form of regulatory dualism than -- as is the custom -- as a form of regulatory competition, and the same can be said of EU corporate law post-*Centros.* The dramatic failure of Germany's *Neuer Markt* illustrates some of the pitfalls of regulatory dualism. If thoughtfully deployed, however, regulatory dualism holds substantial promise in overcoming political barriers to reform, not just of corporate governance and capital markets, but of other economic institutions as well.

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I. Introduction

Countries pursuing economic development confront a fundamental obstacle. Reforms that, by stimulating growth, will increase the size of the overall pie are blocked by groups who, economically successful and therefore politically influential under the existing regime, believe that their positions will be threatened by the growth-inducing reforms.

This problem is conspicuous in developing countries' efforts to establish effective capital markets. Both logic and an increasing -- though not quite conclusive -- body of empirical evidence suggest that economic growth receives strong stimulus from an effective capital market,[1] which in turn requires a substantial and effective legal infrastructure to protect the interests of minority shareholders in publicly traded business corporations.[2]

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[1] A large body of literature has sought to demonstrate the positive influence of financial development on overall economic growth. *See, e.g.*, Robert G. King & Ross Levine, *Finance and Growth*: *Schumpeter Might Be Right*, 108 QUART. J. ECON. 717 (1993) (finding that indicators of financial development are strongly correlated with economic growth, and that predetermined components of financial development indicators significantly predict future growth rates); Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth*, 88 AM. ECON. REV. 537 (1998) (finding a positive correlation between stock market liquidity and banking development and the contemporaneous and future rates of economic growth); Raghuram G. Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559 (1998) (finding that industrial sectors which are more dependent on external finance grow disproportionately faster in countries with well-developed financial markets); Valentina Bruno & Stijn Classens, *Corporate Governance and Regulation: Can There be Too Much of a Good Thing?*, WP 4140, World Bank Pol. Res. (2007) (companies with good corporate governance rely more heavily on external finance), available at http://ssrn.com/abstract=956329.

[2] La Porta, Lopez-de-Silanes, Shleifer and Vishny, in particular, have sought to make the case that, as an empirical matter, strong shareholder protection laws are an important prerequisite for vibrant capital markets and, perhaps, overall economic development. Representative examples of a prominent series of articles are Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny (hereinafter "La Porta et al."), *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998); La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000). Admittedly, the strength of these empirical results has been questioned. *See, e.g.*, Holger Spamann, *On the Insignificance and/or Endogeneity of La Porta et al.'s 'Anti-Director Index' under Consistent Coding* (2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=894301.

This literature also expresses strong views about the causes of varying levels of shareholder protection in cross-country comparisons (common law versus civil law origin of the legal regime), and -- to a lesser extent -- about the detailed content of such reform (the rights in their "anti-director rights index"). These and other law-and-finance claims are not relevant to the problem we address here.

A growing literature has challenged the claim that shareholder protection must come exclusively through legal means, largely by showing that in a number of countries public ownership preceded legal protection – that is, law was demand driven rather than an instrument to develop an ownership structure. *See, e.g.*, Julian Franks, Colin Mayer & Hannes Wagner, *The Origins of the German Corporation – Finance, Ownership and Control*, 10 REV. FIN. 537 (2006); Brian R. Cheffins, *History and the Global Corporate Governance Revolution*: *The U.K. Perspective*, 43 BUS. HIST. 87, 100 (2001); Franklin Allen & Jun Qian, *Comparing Legal and Alternative Institutions in Finance and Commerce* (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1136168 (on China and India). These results are not inconsistent with the claim that a strong legal infrastructure is helpful, and ultimately perhaps essential, to the creation of robust capital markets.

Yet the development of effective shareholder protection to support capital market development commonly threatens already-established firms and their controlling owners. First, it shifts both wealth and corporate power (and ultimately political power as well) away from the controlling owners and toward public shareholders. In particular, by reducing self-dealing, effective minority protection lowers the value of controlling shares. And by constraining control, it also opens governance of the corporation to outside influence. Second, effective shareholder protection facilitates the financing of potential competitors, since new firms generally need outside equity financing more than do well-established firms. These threats give the controlling owners and managers of established firms a powerful incentive to resist expansion of the legal protection afforded shareholders. And, because those owners and managers generally have strong influence over the political process, they are frequently in a position to make their resistance to reform effective.

We will call this resistance of the established economic and political elite to growth-promoting reforms the *Olson problem,* after the economist who has described it most eloquently and insightfully.[3] The question, then, is what can be done to diffuse the tension between future growth and the current distribution of wealth and power.

Olson himself pessimistically suggested the intractability of the tension; in his view, solving the Olson problem may require massive social upheaval, such as revolution or war, which destroys the existing establishment.[4] More optimistic approaches stop short of destroying the elite and instead mitigate their opposition by protecting their interests from the growth-inducing reforms.[5] In this article, we examine one approach of the latter type, which we label *regulatory dualism*.

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[3] MANCUR OLSON, THE RISE AND DECLINE OF NATIONS (1982). Twenty five years after the publication of *The Rise and Decline of Nations*, the balance of more than fifty works attempting to test Olson's theory of institutional sclerosis was found to be positive. *See* Jac C. Heckelman, *Explaining the Rain:* The Rise and Decline of Nations *after 25 Years*, 74 SOUTHERN ECON. J. 18 (2007), for a review of this literature. The political economy of capital market development, in particular, is interpreted in Olson-like terms by Raghuram Rajan & Luigi Zingales, *The Great Reversals*: *The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5 (2003).

Olson-type resistance to capital market development can be seen with particular clarity in the historical experience of England, the first industrial nation. England had arguably achieved sufficient legal and economic sophistication to permit incorporation as a right and broad public markets for corporate stock by the early eighteenth century. It was, however, not until the second half of the nineteenth century that this level of development was achieved. The requisite legal infrastructure was effectively blocked by existing corporations, which sought to defend from well-capitalized competition the effective monopoly conferred by the charter for which they had commonly paid political bribes, and by small unincorporated businesses, which also wished to avoid the strong competition that might be offered them by a publicly-traded corporation with its access to large amounts of capital. *See* RON HARRIS, INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720–1844 (2000)**.** *See also* Franks et. al., *supra* note 2, and Cheffins, *supra* note 2, who argue that in the U.K. reputation allowed local elites to raise public capital, which made public financing available only to the existing elite.

[4] OLSON, *supra* note 5.

[5] In conceptual terms, a strategy of protecting elites so that they will not block reform is similar to Acemoglu and Robinson's development of constrained democracy as a means to persuade the elite not to resort to repression to maintain political and therefore economic power. *See* DARON ACEMOGLU & JAMES A. ROBINSON, ECONOMIC ORIGINS OF DICTATORSHIP AND DEMOCRACY (2006).

Regulatory dualism seeks to avoid, or at least mitigate, the Olson problem by permitting the existing business elite to be governed by the pre-reform regime, while pursuing growth by allowing other businesses to be governed by a reformed regime. Put in terms of capital market and shareholder protection, a dual regulatory strategy establishes a new and more rigorous shareholder protection regime, operating parallel to the existing one, that is open to any new or existing firm that wishes to make use of it. The maintenance of the relationship between controlling and minority shareholders in existing firms insulates the interests of existing elites, while more effective shareholder protection makes public financing available to the entrepreneurial sector, thereby expanding the capital market's capacity to support economic growth.[6]

To be sure, regulatory dualism is not without costs to the elites. Neither, however, are the two more extreme alternatives: comprehensive reform and no reform. These costs can be either economic (a reduction in the elite's wealth) or political (a reduction in the elite's political power and ability to influence regulatory decisions going forward). Comprehensive reform brings a direct transfer of corporate wealth and power to public shareholders, the improvement of financing options available to competitors, and -- as an ultimate consequence -- reduction in the political clout of the currently controlling owners vis-à-vis outside investors and new businesses. On the other hand, seeking to block all reform can be expensive, not just directly but by upsetting the elites' relationship with previous allies, such as government officials and stock exchange owners. Worse, extreme intransigence toward reform could lead to general economic decline harmful to all classes, and might produce a popular backlash seriously damaging to the economic and political position of the current elite.

Given the alternatives, regulatory dualism can provide an attractive option from the elites' standpoint, since it avoids the costs of blocking all reform, dilutes the costs of sweeping legal changes, and reduces the political pressure for more comprehensive reform. A dual regulatory regime preserves the legal entitlements of incumbents, at least initially, thus avoiding the immediate economic and political costs associated with stronger minority investor rights at the firm level. The immediate economic and political costs associated with a dual regulatory regime are principally those stemming from increased competition. But if the new firms are expected to concentrate in different industries than the established ones – the "new" as opposed to the "traditional" economy -- the slope of the incumbents' decline may be gentle enough to allow them to move their wealth out of the old businesses in time. The result is that, even if the elites ultimately lose their economic and political dominance, they can still protect most of their wealth, perhaps permanently.[7]

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[6] Bebchuk and Neeman have modeled the impact of different interest groups on the degree of investor protection. They argue that the political influence of insiders of publicly traded firms leads to an inefficient level of investor protection, a result that is only partially attenuated by countervailing pressures by entrepreneurs who want to take new firms public. Lucian Bebchuk & Zvika Neeman, *Investor Protection and Interest Group Politics*, REV. FIN. STUD. (2009). Regulatory dualism can mitigate these political economy barriers to an efficient level of investor protection by isolating the legal regimes of incumbents from those of new firms seeking to raise equity capital.

[7] The decline may not be linear. The success of the "new" economy and economic growth generally may act as a catalyst for further reform, a possibility that the elite presumably will incorporate in its strategic calculus. As should already be apparent, the outcome of that calculus will depend heavily on local factors;

We introduce the concept of regulatory dualism by examining a recent and apparently successful Brazilian effort directed at capital market development. At the core of the Brazilian approach is the creation, within the São Paulo Stock Exchange, of a "New Market" (*Novo Mercado*) for publicly traded securities that exists parallel to the pre-existing exchange institutions and regulations. The New Market's listing standards are substantially more protective of noncontrolling shareholders than is the old regime -- in particular, prohibiting the use of non-voting stock that allows a shareholder to maintain control without a commensurate equity stake. The New Market is open, on a voluntary basis, to both new and existing firms that are prepared to comply with its requirements.

Brazil's New Market is a paradigm example of regulatory dualism. It is not, however, the only experiment with that regulatory strategy. Germany, for example, tried a similar approach in the late 1990s, only to abandon it as a dramatic failure a few years later. The approach to corporate chartering long taken in the United States also has strong elements of regulatory dualism. Under that approach, controlling shareholders and managers desiring a regulatory regime that will help insulate them from market forces can incorporate in their home state, where they can exercise political influence, while firms for which access to the capital markets on favorable terms is more important can instead incorporate in Delaware, where no class of corporate stakeholders -- controlling or noncontrolling shareholders, managers, employees, or consumers -- has significant direct influence on the political process. Indeed, contrary to the conventional characterization, Delaware corporate law might most appropriately be seen as complementary to, rather than as competitive with, the corporate law offered in other states. Were it not for the protectionist corporate law offered by other states, Delaware's nationally-available market-friendly corporate law might not be politically viable, and vice versa. Similarly, the European Union's recent steps toward permitting free choice of jurisdiction for incorporation also has much of the character of regulatory dualism, leaving established firms to be governed by the pre-existing local corporate and capital markets law shaped by the political power structure of their state of original incorporation, while permitting new firms to seek out the regulatory regime of their choice. We examine below each of these efforts at a dual regulatory strategy.

Our particular focus here is on dual regulatory regimes as a solution to the Olson problem. Dual or multiple regulatory regimes can serve other purposes as well. Most obviously, they can be used to tailor regulatory regimes to the differing functional characteristics of different industries or different types of actors. Variegated regulatory systems of the latter sort are not our focus here. On the contrary, by *regulatory dualism* we refer to the use of two parallel regulatory regimes to govern a set of relatively homogeneous actors for which, in principle, a single regulatory regime would be more efficient. In regulatory dualism, one of the two systems of regulation – the *established regime* – is relatively lax and is maintained to accommodate established firms. The second system – the *reformist regime* – is more rigorous, and is available to existing or new firms that desire to make themselves more credible with the class of patrons whose interests the regulation is designed to protect. If economic efficiency were the only concern, it would be best to apply the reformist regime to all regulated firms. The

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while the structure of the analysis is general, the parameter values will depend on a country's particular circumstances. See Part V(D) *infra*.

principal reason for maintaining the established regime is to reduce the incentive for those who benefit from it to oppose creation of the reformist regime. As we discuss below,[8] regulatory dualism has something in common with simple grandfathering, but differs in, among other things, keeping open to both old and new firms the choice of being regulated by either the established or the reformist regime.

Our exposition proceeds as follows: Part II describes Brazil's recent efforts to reform its equity markets, after decades of political paralysis, through an alternative New Market created within the established stock exchange. Part III describes other efforts at regulatory dualism, including the premium stock exchange segment created in Germany with the Frankfurt "Neuer Markt," as well as the systems of corporate chartering adopted in the U.S. and, much more recently, in the EU. Part IV compares regulatory dualism with related regulatory strategies such as grandfathering, statutory menus, and default rules. Part V explores alternative sources for the reformist regime, from private regulatory organizations to independent foreign states. Part VI discusses regulatory dualism in applications other than corporate law, such as commercial contracting. Part VII concludes.

II. Brazil's New Market

A. Brazil before the New Market

We begin by focusing on Brazil as a prototypical example of regulatory dualism. As we shall see, both the need for reform and the Olson problem were particularly acute in Brazil. Indeed, the New Market experiment was deliberately designed to circumvent the political clout of established firms in obstructing much-needed legislative reform to improve minority investor protection.

During most of its history, Brazil's capital markets were largely underdeveloped and, therefore, unavailable as a stable source of debt and equity financing for companies looking to pursue investment opportunities.[9] As a result, Brazilian corporations relied largely on retained earnings, government and bank loans and, for a handful of large conglomerates, extra-jurisdictional financing in foreign currency.[10] Smaller firms were

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[8] *See* Part IV(A)(1).

[9] Between 1890 and 1914, however, Brazil experienced a period of fairly developed capital markets. Before World War I, Brazil's stock markets were the second largest in Latin America and had an estimated 480 listed companies, the largest number in Latin America. Both the number of publicly traded firms as a percentage of the population and the ratio of bond issues to GDP were higher in 1913 than they are today. *See* Aldo Musacchio, *Law Versus Contracts: Shareholder Protections and Ownership Concentration in Brazil, 1890-1950*, 82 BUS. HIST. REV. 445, 449 (2008), and ALDO MUSACCHIO, EXPERIMENTS IN FINANCIAL DEMOCRACY (2009). For a description of the legal and political environment enabling capital market development in this period, *see* Mariana Pargendler, *Family, Friends and the State: A History of Corporate Law and Governance in Brazil* (2009) (unpublished manuscript, on file with the authors).

[10] *See, e.g.*, Pérsio Arida et al., *Credit, Interest, and Jurisdictional Uncertainty: Conjectures on the Case of Brazil*, *in* INFLATION TARGETING, DEBT AND THE BRAZILIAN EXPERIENCE (Francesco Giavazzi et al. eds., 2005) (describing the absence of a long-term domestic credit market in Brazil); MB Associados, *Desafios e Oportunidades para o Mercado de Capitais Brasileiro* (2000), available at http://www.bmfbovespa.com.br (noting the historical insignificance of Brazilian capital markets and the prominent role of governmental loans as a source of long-term financing).

therefore capital constrained, as bank loans at high interest rates and short maturity terms were their principal financing source. Scholars believe that this scarcity of long-term capital took a substantial toll on development.[11]

Brazil's failure to develop a sustainable capital market was not due to ignorance about the relation between finance and economic development. That the creation of indigenous financial markets was crucial to spur Brazil's industrial and economic growth has periodically emerged as a central political issue since the mid-nineteenth century. Nonetheless, consistent with Olson's predictions, a close look at the country's history reveals that legal reforms attempting to create the preconditions for capital market development invariably faced significant resistance from established interest groups that benefited from the status quo.[12]

The rise of urban elites in the twentieth century only reinforced the link between economic power and political influence in Brazil.[13] While Brazilian corporations in the early twentieth century had more dispersed ownership structures through the provision of voting caps and graduated voting scales,[14] the reduction in influence of agricultural oligarchs in the 1930s created the preconditions for the current model of highly concentrated voting power.[15] In 1932, following a proposal by various business associations,[16] the federal government passed a decree authorizing corporations for the first time to issue preferred non-voting shares.[17] The issuance of non-voting preferred shares would lead to the separation between cash-flow rights and voting rights and an

[11] The impact of a shortage of long-term financing options on economic development in Brazil has been a recurring theme throughout Brazilian history. *See, e.g.*, JOSÉ ANTONIO PIMENTA BUENO, DIREITO PÚBLICO BRAZILEIRO E ANÁLISE DA CONSTITUIÇÃO DO IMPÉRIO (1857) (arguing that governmental restrictions to incorporations in Brazil were delaying the country's development); A MISSÃO COOKE NO BRASIL, RELATÓRIO DIRIGIDO AO PRESIDENTE DOS ESTADOS UNIDOS DA AMÉRICA PELA MISSÃO TÉCNICA AMERICANA ENVIADA AO BRASIL, Fundação Getúlio Vargas (1949); MÁRIO HENRIQUE SIMONSEN, BRAZIL 2002, at 118 (1972) (attributing the disadvantage of private Brazilian firms vis-à-vis their state-owned and foreign counterparts to a lack of financing alternatives); SOLUÇÕES PARA O DESENVOLVIMENTO DO MERCADO DE CAPITAIS BRASILEIRO (Carlos Antonio Rocca ed., 2001) (citing the lack of financing alternatives to the private sector as one of the main obstacles to the international competitiveness of the Brazilian economy).

[12] For a political economy account of corporate law reforms in Brazil throughout its history, *see* Pargendler, *supra* note 9.

[13] *See* RAYMUNDO FAORO, OS DONOS DO PODER: FORMAÇÃO DO PATRONATO POLÍTICO BRASILEIRO 495 (3rd ed., 2001).

[14] *See* Musacchio, *supra* note 9.

[15] Historians cite Brazil's 1930 "revolution" – a coup d'état that put an end to a 40-year old period in which an alliance of agrarian oligarchies of the country's two wealthiest states dominated national politics -- as a symbol the apparent demise of agricultural oligarchies' central role in national politics and consolidation of an urban and industrial economic social structure.

[16] In 1931, the Rio de Janeiro Commercial Association, Brazil's Federation of Business Associations and the Association of Banks of Rio de Janeiro submitted to the government a draft statute authorizing the issuance of non-voting preferred shares, a version of which was ultimately adopted. *See* ERNESTO LEME, DAS AÇÕES PREFERENCIAIS NAS SOCIEDADES ANONYMAS (1933).

[17] The Corporations Law of 1940 subsequently capped the issuance of non-voting preferred shares at 50% of a company's total equity capital, a limit which was raised to 2/3 of total capital in 1976. Unless the company's bylaws provided otherwise, the financial rights of non-voting preferred shares in Brazil were by and large akin to those of common shares. It was not until the legal reforms of 1997 and 2001 that firms were required to grant special advantages (such as favorable dividend treatment, or tag-along rights) to preferred non-voting shares.

extreme concentration of voting shares in the hands of family groups and the State in the following decades.[18] By the time of the enactment of a new Corporations Law in 1940, public subscriptions were virtually non-existent and the tightly-controlled firm had become the model for private Brazilian enterprise.[19]

At least since the mid-twentieth century, scholars and policymakers have identified the lack of adequate minority investor protection as a major hurdle to capital market development in Brazil.[20] Nevertheless, when the military government undertook to promote capital market development in the 1960s, it adopted an "all-carrot-no-stick" strategy which granted generous tax incentives for companies to go public without implementing substantive legal reforms. Scholars at the time hoped that, despite Brazil's apparent deficiencies in protecting shareholders and creditors, institutional reform could follow, rather than precede, the growth in the country's capital markets.[21]

The incentives policies encompassed tax cuts for both publicly traded companies and their investors, as well as a program allowing taxpayers to allocate part of their federal income tax to make personal investments in listed firms.[22] The upshot of this program was rapid capital market growth, but not the creation of a sustainable source of market financing. Academic supporters of the government's incentives policy later acknowledged that their confidence in the programs was mistaken, and that they had underestimated the State's capture by powerful economic groups.[23]

While these policies failed to establish sustainable capital markets, they succeeded in erecting hefty barriers to future law reforms. The tax incentives of the 1960s and 1970s triggered dramatic growth in the number of Brazilian publicly traded

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[18] *See* Part II(b) *infra*.

[19] *See* TRAJANO DE MIRANDA VALVERDE, SOCIEDADE POR AÇÕES (for the views of the author of the draft of the 1940 corporate statute).

[20] *See* MISSÃO COOKE, *supra* note 11, at 91 (proposing that Brazil adopt a system of shareholder protections similar to that available in the United States in order to overcome investors' aversion to equity markets); O MERCADO BRASILEIRO DE CAPITAIS 64 (EPEA, 1965) (stating that the Corporations Law failed to provide the degree of shareholder protection necessary for capital market development); SIMONSEN, *supra* note 11, at 124 (arguing that Brazil's tradition of closely-held family firms was not due to sociological traits, but to the failure of existing corporate laws to adequately protect minority shareholders).

[21] David M. Trubek, *Toward a Social Theory of Law*: *An Essay on the Study of Law and Development*, 82 YALE L. J. 1, 45-6 (1972) (although it was well known that "the rules governing creditor and shareholder rights were imperfect, that courts were neither accessible nor efficient, and that sanctions were ineffective," there was initial hope that "as the markets boomed they would generate pressure for improvement in the private system"). This position has since been found to have some historical precedent. In both the United Kingdom and Germany, shareholdings became more dispersed before effective minority shareholder protection was adopted. *See* Franks et al., *supra* note 2; Julian Franks et al., *Spending Less Time with Family: The Decline in Family Ownership in the UK*, in THE HISTORY OF CORPORATE GOVERNANCE AND THE WORLD 582 (Randall Morck ed., 2005) (timing of dispersal of shareholdings in the UK).

[22] For a detailed description of the tax incentives policies adopted in Brazil, *see* DAVID M. TRUBEK ET AL., O MERCADO DE CAPITAIS E OS INCENTIVOS FISCAIS 113 (1971).

[23] *See, e.g.,* Trubek, *supra* note 21, at 48 (acknowledging that "the emerging structure of the Brazilian financial market seems to be one in which a very few powerful groups are actively supported by government policy, and where the government, in turn, is just as dependent on the success of these groups" and that "state intervention in the economy is not pure command, but favors certain economic actors over others, so that predictability for the state and the powerful groups is a consequence of their mutual dependence.")

companies.[24] As a result, the same family-controlled corporations that were induced to go public by the government became a powerful interest group that would later block legal changes to improve minority protections; reforms would divert both wealth and power to the large ranks of new public shareholders. In 1971 the controlling shareholders of publicly traded firms founded the Brazilian Association of Public Companies, a lobby group which would become highly successful in opposing investor protection reforms.[25] Moreover, the 1960s saw a rapid proliferation of state-owned enterprises in Brazil, many of which were publicly traded.[26] As a result, the State itself, as a controlling shareholder of the largest listed corporations in Brazil,[27] would have independent reasons to oppose legal reforms that could transfer wealth to minority shareholders in subsequent years.[28]

While legal reform to support capital market development remained on the government's public agenda, such reform as occurred was ineffective. A new Corporations Law enacted in 1976 was officially aimed at establishing the "requisite legal structure to strengthen the country's capital markets" through the "creation of a regime that assures to minority shareholders the respect for clear and equitable rules."[29] Yet, despite the statute's expressed good intentions and a very contentious legislative effort to include additional minority protections,[30] the overall contribution of the new law to improved investor rights was modest.

The Olson problem was particularly apparent in the failed efforts to improve minority shareholder protection in the new Corporations Law. To begin with, the new law resolved the ongoing dispute over limits on the dilution of voting rights in favor of controlling families: the statute actually *increased* the ceiling for the issuance of non-voting preferred shares from 50% to up to 2/3 of the firm's total equity capital, which

[24] The São Paulo Stock Exchange had 200 listed companies in 1970; by 1977 the number had reached 452. MB Associados, *supra* note 10, at 30.

[25] *See* note 31 *infra* and accompanying text; *see* also Luciano Coutinho & Flavio Marcilio Rabelo, *Brazil: Keeping It in the Family* 49, *in* CORPORATE GOVERNANCE IN DEVELOPMENT: THE EXPERIENCES OF BRAZIL, CHILE, INDIA AND SOUTH AFRICA (Charles P. Oman ed., 2004) (describing the role of the Brazilian Association of Public Companies, as a "traditional representative of the business elite," in successfully opposing corporate governance reforms in 2001).

[26] *See, e.g.*, Wilson Suzigan, *As Empresas do Governo e o Papel do Estado na Economia Brasileira*, *in* ASPECTOS DA PARTICIPAÇÃO DO GOVERNO NA ECONOMIA 90 (Fernando Rezende et al. eds., 1976) (noting that the highest rate of creation of state-owned enterprises occurred after 1964); THOMAS J. TREBAT, BRAZIL'S STATE-OWNED ENTERPRISES: A CASE STUDY OF THE STATE AS ENTREPRENEUR 59 (1983) (stating that the participation of state-owned enterprises in the list of the largest Brazilian firms soared from 12 in 1962 to 23 in 1975).

[27] *See* Visão, *Brazil Report – A Who's Who of the Brazilian Economy* 46 (1974) (reporting that state-owned enterprises held nearly 50% of the total net book value of the 1,000 largest firms in Brazil); MÁRIO HENRIQUE SIMONSEN, A NOVA ECONOMIA BRASILEIRA (1974) (noting that out of the 20 largest Brazilian companies as of 1972, 11 were state-owned enterprises, 7 were controlled by foreign investors and only 2 were controlled by Brazilian private capital).

[28] *See* Pargendler, *supra* note 9 (describing how the alignment of alignment of interests between wealthy controlling families and the State itself, as the controlling shareholder of the largest Brazilian firms, consistently eroded minority shareholder rights in Brazil).

[29] Federal Law 6,404/76, as amended, remains Brazil's principal corporate law statute.

[30] *See* MODESTO CARVALHOSA, NOVA LEI DAS SOCIEDADES ANÔNIMAS: SEU MODELO ECONÔMICO 11 (1977). Even though the House had only one week to introduce changes to the initial draft, the representatives produced 240 proposed amendments, which were largely aimed at eliminating a multitude of new privileges to financial conglomerates. *Id.* at 12.

meant that a shareholder could sustain uncontested control of a firm by holding less than 17% of the company's total equity.

Similarly, a Senate amendment to the bill adding a mandatory bid requirement for minority shares in the event of a change of control (so-called "tag-along rights") triggered a forceful reaction by the Brazilian Association of Public Companies, which launched a campaign demanding a presidential veto of this section of the statute.[31] The president refused to exercise his veto power,[32] but only seven days after the Corporation Law came into force, the federal government issued an "interpretative" decree stating that tag-along rights only applied to *voting* shares held by minority investors.[33] Because public shareholders held mostly non-voting shares, the decree's interpretation, which was upheld in court,[34] significantly eroded this minority protection.

After a "lost decade" of debt crisis, stagflation, and sharply decreasing growth rates in the 1980s, Brazil initiated a modernization strategy in the 1990s that, inspired by the Washington consensus, replaced import-substitution subsidies with international competition and inaugurated a comprehensive privatization process. The reduction in the barriers to foreign capital enabled a major influx of foreign investment into the country, and the São Paulo Stock Exchange saw a significant increase in its market capitalization compared to prior periods.[35] Yet, at the same time that Brazil's market capitalization reached record levels, there was a steady decline in the number of publicly listed firms and in the liquidity of local markets.[36] By December 1997, a single company, the telecom firm Telebrás, accounted for almost 60% of the Brazilian market's trading volume. This was in large part a direct consequence of a government-sponsored reform to the Corporations Law in 1997.[37] This new law removed even the limited statutory protections then available to minority shareholders upon control sales, such as statutory appraisal rights at book value and the remaining tag-along rights, in order to allow the federal government to maximize its privatization proceeds. Commentators denounced the project as a confirmation of how the oligarchic character of Brazilian capitalism hindered the creation of effective capital markets.[38]

By promoting acquisitions without exit opportunities for the minority, the abolition of tag-along rights exposed the serious deficiencies in the legal protection of minority shareholders in case of freeze-outs and going private transactions. There were, for example, no legal impediments to undisclosed share purchases by controlling

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[31] *Id.*, at 17.
[32] Partial presidential vetoes were, and still are, legally permissible in Brazil.
[33] *See* CARVALHOSA, *supra* note 30, at 17.
[34] Courts upheld the decree's interpretation. *See* NELSON EIZIRIK, RERFORMA DAS S/A E DO MERCADO DE CAPITAIS 113 (1997).
[35] The ratio of stock market capitalization to GDP in Brazil jumped from an average of 8% in the 1980s to an average 26.3% between 1993 and 1998, while the ratio of trading volume to GDP increased from 2.7% to 15.6% in the same periods. MB Associados, *supra* note 10, at 25. By the early 1990s São Paulo's had become the only active stock exchange in Brazil, as a scandal involving default by a major speculator in the options market in the late 1980s led to the demise of the Rio de Janeiro Stock Exchange.
[36] As a result, the trading volume on the Bovespa fell from more than $191 billion in 1997 to $101 billion in 2000 and $65 billion in 2001 (available at www.bovespa.com.br).
[37] Federal Law 9,457/1997.
[38] MODESTO CARVALHOSA, COMENTÁRIOS A LEI DE SOCIEDADES Anônimas LXXVIII (4th ed., 2002).

shareholders in the public market. Moreover, as delisting tender offers were not then subject to appraisal or fairness requirements, many companies went private through the payment of offer prices below the book value of the company.[39] Subsequent estimates indicated that Brazil had the highest levels of private benefits of control among 39 countries surveyed for the decade between 1990 and 2000.[40]

The expectation of minority expropriation depressed share prices, which in turn deterred further offerings. Brazilian companies that still sought equity investments at reasonable valuations did so by circumventing local markets and listing almost exclusively on the New York Stock Exchange (NYSE), thereby piggybacking on more protective NYSE listing requirements and on the application to foreign issuers of elements of U.S. securities laws that accompanied NYSE listing.[41] However, a NYSE listing provided an alternative to only a limited range of firms; such a listing was too expensive for small Brazilian issuers, which then lacked not only equity financing but also long-term debt financing options in the private sector.[42]

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[39] Maria Helena Santana, *The Novo Mercado* 1, 12 *in* FOCUS – NOVO MERCADO AND ITS FOLLOWERS: CASE STUDIES IN CORPORATE GOVERNANCE REFORM (The International Finance Corporation, 2008).

[40] Alexander Dyck & Luigi Zingales, *Private Benefits of Control*: *An International Comparison*, 49 J. FIN. 538 (2004). Dyck and Zingales compared the price paid for a controlling block to the market share price following the change of control in a sample of 393 transactions, and found that private benefits of control ranged from -4% in Japan to 65% in Brazil. *Id.* According to a different study, which used dual-class price differentials to estimate private benefits of control, an average Brazilian controlling shareholder could expect to extract up to 33.3% of the value of the company by holding as little of one sixth of total cash flow rights. *See* Tatiana Nenova, *The Value of Corporate Votes and Control Benefits*: *A Cross-Country Analysis* (2000), 68 J. FIN ECON. 325, 327 (2003).

[41] Some scholars have advanced a "bonding hypothesis" to explain the cross-listing of foreign issuers on U.S. exchanges. According to this theory, firms opt to subject themselves to higher disclosure standards and prospects of enforcement in the United States in order to credibly commit to minority protection and lower their cost of capital. For a description of this argument in the legal literature, *see* John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 235 (2007). For empirical works supporting a bonding hypothesis, and finding a premium associated with U.S. cross-listings, *see* Craig Doidge et al., *Why Are Foreign Firms Listed in the U.S. Worth More?*, 71 J. FIN. ECON. 205 (2004) (finding that foreign firms cross-listed in the U.S. had a Tobin's q ratio 16.5% higher than other companies from the same countries); Craig Doidge et al., *Has New York Become Less Competitive than London in Global Markets? Evaluating Foreign Listing Choices Over Time*, 91 J. FIN. ECON. 253 (2009) (stating that the U.S. cross-listing premium persists after the enactment of the Sarbanes-Oxley Act and cannot be replicated by a London cross-listing). Nevertheless, there is also evidence of deficient enforcement of securities laws against foreign firms cross-listed on the U.S. vis-à-vis their domestic counterparts. *See* Natalya Shnitser, *A Free Pass for Foreign Firms? An Assessment of SEC and Private Enforcement Against Non-U.S. Issuers*, __ YALE L.J. __ (2009).

[42] *See supra* note 10 and accompanying text. Virtually the only local source of long-term financing was the Brazilian National Development Bank (BNDES), which offered generous long-term loans at below-market interest rates to the private sector. Nevertheless, politics and its historical industrialist focus rendered the Bank an imperfect substitute for effective capital markets. *See*, *e.g.*, JOHN H. WELCH, CAPITAL MARKETS IN THE DEVELOPMENT PROCESS: THE CASE OF BRAZIL (1993) (noting that the scarcity of BNDES funds in the 1960s led to the adoption of "non-economic" criteria in financing decisions); ANNIBAL V. VILLELA & WERNER BAER, O SETOR PRIVADO NACIONAL 234 (1980) (citing the Bank's guarantee requirements as a disadvantage to small and medium firms, and noting the widespread perception that public financing mainly benefits large companies); Claudio L.S. Haddad, *Experiência Internacional e Desafios para o Mercado de Capitais Brasileiro* 184, *in* MERCADO DE CAPITAIS E CRESCIMENTO ECONÔMICO (Edmar Lisboa Bacha & Luiz Chrysostomo de Oliveira Filho eds., 2005) (arguing that the availability of BNDES's

By the turn of the century, the prospects for Brazilian capital markets looked increasingly grim. Only eight companies had launched an IPO on the São Paulo Stock Exchange (*Bolsa de Valores de São Paulo* – Bovespa)[43] between 1995 and 2000.[44] Following a study by prominent Brazilian economists commissioned by the São Paulo Stock Exchange,[45] the Exchange confronted the fact that inaction both by it and the legislature threatened the very survival of Brazilian capital markets.[46] The result was the Exchange's design of a dual regulatory regime aimed at curing, for new firms, the main legal deficiencies in investment protection and bypassing the political barriers to reforming the legal regime that protected existing public firms. The final product was the Exchange's December 2000 launch of the *Novo Mercado* (New Market), a premium exchange listing segment subject to listing requirements that imposed much stricter corporate governance rules than those provided under Brazilian law.[47]

B. The New Market Standards

When the São Paulo Stock Exchange took up the problem of reform, the contemporaneous success of the Deutsche Borse's initiative with the *Neuer Markt* offered an attractive model. The Brazilian effort, however, was much more ambitious. The German experiment, which we describe in more detail below, was aimed only at attracting high-tech firms. The Brazilian New Market, in contrast, did not focus on a particular industry or type of firm. Both old and new firms in any industry were welcome to join the New Market so long as they were willing to comply with its requirements.

From the outset, the São Paulo Stock Exchange's goal was to address the flaws in the investor protection regime plaguing local capital markets. Following a broad consultation process with various local and foreign market participants, public agencies, and investors, the Exchange created a standard that would operate like a privately-created

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subsidized funds precisely to Brazil's most powerful constituents delayed pressures for the development of a capital market infrastructure).

[43] Bovespa merged with São Paulo's Commodities and Futures Exchange (*Bolsa de Mercadorias e Futuros* – BM&F) in 2007 to form BM&F Bovespa, a publicly-traded firm listed on the New Market.

[44] Santana, *supra* note 39, at 9.

[45] MB Associados, *supra* note 10.

[46] Cally Jordan & Mike Lubrano, *How Effective Are Capital Markets in Exerting Governance on Corporations? Lessons of Recent Experience with Private and Public Legal Rules in Emerging Markets* 20, available at http://ssrn.com/abstract=323163 (describing the creation of Novo Mercado as a "quasi-private effort to make up for the perceived shortcomings of legislative reform").

[47] While the Brazilian Congress finally amended the Corporations Law in late 2001, the Olson problem was again apparent: the reform was quite limited. The statute continued to permit the issuance of non-voting preferred shares, but the ratio to total capital was reduced from 2/3 to 50% for new firms, which still allowed a significant decoupling of voting and equity ownership. The 2001 law also reintroduced tag-along rights, but only partially: they applied only to voting common shareholders and not to the non-voting preferred shares generally held by minority investors, and they entitled shareholders to receive only 80% of the price paid for the controlling block. Other protective provisions in the statute – such as the right of minority shareholders to call a special meeting to deliberate on transactions tainted by the controlling shareholders' conflicts of interest – were vetoed by Brazil's President. In his official justifications, the President alleged reasons of public interest to veto the provision as "innocuous" to the protection of minority shareholders, as controlling shareholders could not possibly be excluded from voting on company matters.

law for publicly-traded business corporations. The idea was that a contractual solution would circumvent the persistent legislative capture thwarting legal reform.[48]

The New Market listing standards were entirely voluntary. A company had to choose to subject itself to the higher standards; companies could choose to remain on, or list initially, on the traditional segment. The strategy was to attract new firms that had an interest in obtaining equity capital at the lower cost that would result from more stringent corporate governance protection for shareholders. Because the New Market left intact the regime applicable to old firms, it served to defuse the Olson problem by diluting -- or at least deferring -- the threat to established interests.

This is not to say that old firms were indifferent to these developments. On the contrary, they showed a keen interest in seeing the New Market initiatives fail. In classic Olson fashion, most of the opposition came from large and well-established Brazilian corporations that, having a strong presence in Brazil's capital markets and access to international financing sources, saw little to gain from this new project. The Brazilian Association of Public Companies employed the "one-size-does-not-fit-all" argument that is typical of its counterparts in developed markets,[49] warning that the adoption of alien corporate governance standards unsuited for local conditions could harm the performance of Brazilian corporations.[50] Yet this reaction from old firms was significantly milder than their successful efforts to block or dilute previous legislative proposals.

The dual regulatory approach goes a long way in explaining the established firms' complacency vis-à-vis the New Market. Unlike legislative reform, the New Market regime did not affect the existing firms' legal rights and duties; there was no wealth or power transfer from controlling shareholders to minority shareholders of legacy companies. On the contrary, old firms may have thought that the New Market could in fact serve to reduce the demand for comprehensive statutory reform.[51] While these firms also feared being stigmatized for "suboptimal governance" if they failed to embrace the New Market requirements, the fact that the new and old standards were both permitted in the future offset somewhat the negative connotation.[52]

But even though regulatory dualism prevents the old firms from suffering the adverse distributive consequences of minority protection reforms, it does little to address the competitive threat that would result from capital market development. Various explanations exist for why the existing Brazilian firms likely viewed the potential for increased competition due to the success of new firms as sufficiently remote as not to pose a real and present danger. First, the New Market was an untested experiment and its

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[48] CALIXTO SALOMÃO FILHO, NOVO DIREITO SOCIETÁRIO 58 (2006).

[49] For a similar stance from the association of chief executives of large U.S. public corporations, *see*, *e.g.*, The Business Roundtable, *Statement on Corporate Governance* (1997), available at www.ecgi.org (asserting that "[g]ood corporate governance is not a "one size fits all" proposition, and a wide diversity of approaches to corporate governance should be expected and is entirely appropriate").

[50] *See, e.g.*, *Relatório Anual da Diretoria* (2005), available at www.abrasca.org.

[51] Indeed, following the creation of the New Market the Brazilian Association of Public Companies began to argue that legal reforms banning non-voting preferred shares were unnecessary, precisely because "voluntary market mechanisms" had emerged to address this issue. *See Relatório Anual da Diretoria* (2006) at 24, available at www.abrasca.org.

[52] Santana, *supra* note 39, at 12.

very potential for success was highly uncertain at the outset.[53] Since capital market development is notoriously hard to achieve,[54] the political costs of opposing such an improbable project likely outweighed the expected benefits. Second, the most influential members of the corporate establishment – state-owned enterprises and family-controlled conglomerates – were in any case unlikely to be direct competitors of the medium-sized firms that were initially expected to pursue a New Market listing.[55] Finally, the increased foreign competition to which they were being exposed by the worldwide opening of trade in recent years may have made the reforms, even if successful, more palatable: poor access to capital in Brazil would not inhibit Brazilian firms' foreign competitors, and might even hinder established Brazilian firms in confronting that foreign competition.[56] All in all, then, the New Market looked like a relatively unthreatening compromise.[57]

As adopted, the overall reform encompassed a four-level system of listings, which offered progressively higher levels of minority shareholder protection:

(1) Pre-Existing Legal Rules

(2) Level 1

(3) Level 2

(4) New Market

The less restrictive of the new levels – named Level 1 and Level 2 – were given requirements more palatable to existing companies. For example, they do not restrict the issuance of preferred non-voting shares. The goal of this graduated scale was to garner support from existing firms; it gave them the opportunity to receive a good corporate governance seal for taking part in the premium corporate governance standards – by moving up, if they chose, from the existing rules to Level 1 or Level 2 – while making few, or really none, of the meaningful concessions requisite for a New Market listing.

1. New Market Listing Rules

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[53] As described in Part II(E) *infra*, the New Market took a while to take off after it was adopted. Two years after its creation, commentators were skeptical of governance reforms through stock exchange standards, and attributed the "weak response" to the New Market experiment to its inability to compete with the stronger "reputational brand" of the NYSE. John C. Coffee, *Racing Towards the Top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1807-8 (2002).

[54] *See*, e.g., Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 782 (2001).

[55] *See* MB Associados, *O Mercado de Capitais Brasileiro Frente aos Desafios Impostos pelas Negociações Internacionais em Serviços Financeiros* 27 (2002), available at www.bmfbovespa.com.br (noting that the New Market initially aimed at attracting medium-sized firms with ongoing investment projects).

[56] *See* Rajan & Zingales, *supra* note 3, at 7 (arguing that "when a country's borders are open to both trade and capital flows (…) the opposition to financial development will be most muted and development will flourish").

[57] The São Paulo Stock Exchange was sensitive about not unduly upsetting existing firms, which constituted, after all, its principal clientele. The initial project aimed at creating a single alternative regime – the one-share-one-vote New Market. This proved, however, too demanding for the appetite of most old companies. Consequently, a more accommodating solution was settled upon, which involved the creation of a series of three new graduated levels of regulation that culminated in the New Market.

The central feature of the highest level, the New Market, was a one-share-one-vote requirement.[58] This stricture allowed issuers who listed on the New Market to credibly commit to forgo the myriad of expropriation opportunities which controllers have historically used to exploit non-voting preferred shareholders. Prior to the New Market, the typical ownership structure of a Brazilian publicly-traded company featured the simultaneous presence of a controlling shareholder and a thoroughly disenfranchised set of public shareholders. Through the extensive use of non-voting stock and, to a lesser extent, pyramidal structures, controlling shareholders in Brazil had a significant majority of a company's voting rights, but typically a minority of its cash-flow rights.[59] Indeed, Brazil had both the world's largest number of dual-class firms,[60] and the largest average gap between cash-flow and voting rights.[61] In economic terms, this ownership pattern produced two classical types of corporate agency problems – those resulting from the absence of any external check on the controlling shareholder's performance in managing the firm, and those resulting from controlling shareholders' incentives to engage in theft and tunneling.

The New Market's prohibition of non-voting shares had two direct benefits: it reduced the opportunities for abuse by giving minority shareholders the ability to voice their concerns and to attempt to influence corporate action, and – by removing the substantial wedge between voting and cash-flow rights in most Brazilian public firms – it limited the controlling shareholders' incentives to expropriation. A large shareholder could maintain control, but at the cost of maintaining a matching equity investment, which would then serve to better align the interests of controlling and minority shareholders.

Voting caps and pyramidal structures are not prohibited under existing New Market regulations, although the São Paulo Stock Exchange is considering an amendment to that effect.[62] The proposed dual-class recapitalization of New Market firm Cosan – which, by taking place at the holding company level, would leave the listed company in formal compliance with the segment's listing requirements – raised concerns that companies would begin using alternative transaction structures to circumvent the New

[58] We use the term "one-share, one-vote" loosely to describe the absence of non-voting shares. Voting caps and pyramidal structures are not yet prohibited under the current New Market regulations, although the São Paulo Stock Exchange has recently proposed an amendment to this effect. *See* notes 63 and 64 *infra* and accompanying text.

[59] *See, e.g.*, Nelson Eizirik, *O Mito do 'Controle Gerencial' – Alguns Dados Empíricos*, 66 REVISTA DE DIREITO MERCANTIL 103, 104 (1987) (finding that, in a sample of 476 Brazilian public companies in 1985, controlling shareholders held, on average, nearly 70% of the company's voting stock); André Carvalhal-da-Silva & Ricardo Leal, *Corporate Governance, Market Valuation and Dividend Policy in Brazil*, 1 FRONTIERS FIN. & ECON. 1 (2004) (finding that, as of 2000, the largest shareholder in their sample of 225 firms held, on average, 72% of the company's voting stock and 51% of its total capital); Ricardo P.C. Leal & André Carvalhal da Silva, *Corporate Governance and Value in Brazil (and in Chile)* (2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=726261 (noting a rise in the concentration of voting rights in Brazilian firms from 1998 to 2002).

[60] Andre Carvalhal da Silva & Avanidhar Subrahmanyam, *Dual-Class Premium, Corporate Governance and the Mandatory Bid Rule: Evidence from the Brazilian Stock Market*, 13 J. CORP. FIN. 1, 4 (2007).

[61] Tatiana Nenova, *Control Values and Changes in Corporate Law in Brazil* (2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=294064.

[62] *Recomendações da Câmara Consultiva do Novo Mercado* (2009) [hereinafter "Recommendations"], available at www.bmfbovespa.com.br.

Market's rules.[63] In response to these developments, the BM&F Bovespa Working Group recently proposed the adoption of a new and broader listing standard clarifying that any structures leading to a direct or indirect violation of the New Market's rules and principles will be deemed a violation of the segment's listing requirements.[64]

The New Market also requires that issuers provide tag-along rights to all shareholders at the same price per share paid for the controlling block. To be sure, the efficiency of tag-along rights remains subject to debate.[65] In a regime that tolerates an overall high level of private benefits of control, tag-along rights allow minority shareholders to exit at a fair price upon control sales and therefore restrict the ability of a controlling shareholder to receive the capitalized value of the private benefits of control. Tag-along rights thus operate as a structural protection device that reduces the value of private benefits, albeit at the cost of preventing some efficient control transfers.[66]

New Market firms also must commit to stricter transparency, liquidity, and board independence standards. The additional transparency requirements range from the disclosure of ownership and trading by controlling shareholders and board members to the preparation of financial statements in accordance with International Financial Reporting Standards (IFRS) or U.S. Generally Accepted Accounting Principles (U.S. GAAP). In addition, New Market firms must have a board of directors with a minimum of five members, of which 20 percent must qualify as independent, and must maintain a 25 percent minimum free float of its stock.[67]

The listing rules also constrain the ability of controlling shareholders and managers of New Market firms to renege on their initial commitment to stricter corporate governance standards by simply exiting the segment. Persons wishing to delist a firm from the New Market must first launch a tender offer for the firm's shares at a price at

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[63] Cosan Ltd., a Bermuda holding company controlled by the controlling shareholders of Cosan, extended an offer to New Market shareholders to exchange their common shares in Cosan for BDRs (Brazilian Depositary Receipts) of Class A shares in Cosan Ltd. Class A shares have the same rights as Cosan shares, but Class B shares, held by the controllers, entail ten votes per share. Reginaldo Alexandre, *Isonomia de Voto no Novo Mercado sob Ameaça*, GAZETA MERCANTIL (July 26, 2007). The offer ultimately failed to attract sufficient shareholders to delist Cosan from the New Market, but the incident served as a warning about the risks of evasion of the segment's requirements. *Brazil's Cosan to Stay on São Paulo Exchange*, REUTERS, Apr. 22, 2008.

[64] *Recommendations*, *supra* note 62.

[65] For a discussion of the economic properties of a mandatory bid rule, *see* Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 716, 737 (1982) (arguing that unequal sharing of gains in corporate control transactions maximizes shareholder wealth); Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 1994 Q.J. ECON. 957 (positing that the "equal opportunity rule" followed in other countries may lead to an increase in the incidence of controlling shareholder structures compared to the market rule followed in the United States); Marcel Kahan, *Sales of Corporate Control*, 9 J. L. ECON. & ORG. 368 (1993) (arguing that equal sharing rules may be less efficient than private control transfers for sales of high fractions of corporate shares).

[66] The tradeoff between encouraging efficient transactions and protecting minority investors from expropriation upon control sales in countries lacking adequate regulation of going-private transactions remains open to investigation. From a description of different modalities of extraction of private benefits of control in operating decisions, control sales and freeze-outs, *see* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 787 (2003).

[67] This means, specifically, that at least 25% of outstanding shares must not be held by the controlling shareholder, senior management, directors, or parties related to those persons.

least equal to their economic value.[68] The tender offer requirements also apply to delisting decisions by the Exchange for violations of listing rules.[69] In addition, the New Market regulations permit the BM&F Bovespa to impose fines and suspend stock trading in case of non-compliance with the segment's standards.[70]

The Level 2 requirements track those of the New Market except that non-voting shares are permitted and tag-along rights are limited compared to the New Market. Level 2 firms must offer tag-along rights to common shareholders at the same price paid to the controlling shareholders, but preferred non-voting shareholders are entitled to receive only 80% of the price paid for the controlling block.[71] The Level 2 tag-along rights are, nonetheless, more protective than those available under existing corporate law.[72]

Level 2 firms must also grant non-voting preferred shareholders the right to vote on certain major corporate actions, including mergers, spin-offs, and asset appraisals in connection with capital increases. In addition, Level 2 companies undertake the same broader disclosure obligations as New Market companies.

Level 1 is the most lenient of the new listing standards. The listing requirements impose no new substantive minority rights per se, but only enhanced disclosure and free float requirements. In fact, because subsequent amendments to the Corporations Law and changes in regulations by the Brazilian Securities and Exchange Commission are transforming most of the New Market disclosure requirements into law, labeling Level 1 as a premium corporate governance standard is fast becoming a misnomer.[73] As a result,

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[68] Novo Mercado Listing Rules, Section 11.
[69] Novo Mercado Listing Rules, Section 12.
[70] *Id.* There is empirical support for the link between better corporate governance and better corporate performance in Brazil. Based on a large sample of publicly traded Brazilian firms, Bernard Black, Antonio Gledson de Carvalho and Erica Gorga find a positive statistically significant relation between quality of governance and corporate performance as measured by Tobin's *q*. Interestingly, when the measure of corporate governance is broken down, the positive relationship between minority protection and firm performance remains, but the relation between independent directors and firm performance turns negative. Bernard Black et. al., *Does One-Size-Fit-All in Corporate Governance? Evidence from Brazil* (working paper, 2009), available at http://ssrn.com/abstract=1434116. The importance of minority shareholder protection in Brazil is straightforward; however, the results with respect to independent directors suggest an interaction between the presence of controlling shareholders and independent directors that may be peculiar to Brazil. Because the sample of firms is based on a 2004 survey, it includes only four New Market firms. Inclusion of a larger number of firms listed on New Market, characterized by multiple blockholders as opposed to a controlling shareholder, see TAN 82, may help identify this interaction.
[71] The Working Group in charge of revising the premium listing standards has recently proposed a new listing rule obligating Level 2 firms to grant tag-along-rights at 100% of the price paid for the controlling block.
[72] Under the 2001 reforms of the corporate law, which govern corporations that have not adhered to the higher standards provided by the New Market or Level 2, common shareholders have tag-along rights at 80% of the control sale price, while preferred shareholders have no such rights at all.
[73] The Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários – CVM) was established by the Capital Markets Law (Law 6,385) in 1976, the same year as the enactment of the then new Corporations Law. The subsequent amendments to the Corporations Law in 1997 and 2001 increased CVM's autonomy vis-à-vis the executive and expanded the scope of its regulatory oversight and disciplinary authority. Nevertheless, CVM's punitive power remains modest compared to its counterparts in other jurisdictions, and the U.S. in particular. The Brazilian Capital Markets Law, as amended, caps the maximum monetary penalties that the CVM can impose for regulatory violations at the greater of R$500,000 (approximately US$250,000) and three times the amount of the illicit gain. During the 1990s,

the BM&F Bovespa Working Group in charge of revising the requirements for the premium listing segments has recently proposed the elimination of Level 1 altogether. If approved, firms listed on Level 1 would be required to either migrate to the more demanding Level 2 or New Market, or return to the traditional segment.[74]

C. The Complementary Contractual Framework

Analysis of the new multiple listing requirements standing alone paints an incomplete picture of the legal framework that has encouraged firms to list on the New Market. New Market listed companies have supplemented the stock exchange rules with a sophisticated contractual infrastructure designed to support Brazilian firms in moving to a one-share, one-vote regime.

The New Market ban on non-voting shares reduces the incentive for an existing controlling shareholder to divert to itself a disproportionate amount of corporate income by forcing the controlling shareholder to own equity proportionate to its voting power. However, it does not fully eliminate the incentive for controlling shareholder opportunism. Consequently, there remains the risk that, in the absence of a controlling shareholder, an outsider can obtain control through the market and then begin exploiting the minority.[75] To address this problem, New Market firms began adopting two types of private contractual arrangements to prevent a new shareholder from acquiring control of the firm in the market without paying a control premium, i.e., without paying for the right to a disproportionate share of the income:[76] (1) shareholder agreements and (2) mandatory bid rules in the companies' bylaws.

1. Shareholder Agreements

The widespread use of shareholder agreements in Brazil well precedes Bovespa's expanded listing segments, but the 2001 amendments to the Corporations Law facilitated the adoption of largely self-enforceable shareholder agreements.[77] A recent survey shows that New Market firms are more likely to be party to a shareholder agreement than

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the CVM in fact apparently opposed legislative projects aimed at increasing minority shareholder rights. *See* CARVALHOSA, *supra* note 38 at LXXIV-VI. In the last decade, however, the Commission has taken a more activist stance toward investor protection. Since 1999, when it enacted various regulations (albeit of dubious legality) aimed at reinstating investor protections in going-private transactions, the CVM has adopted an increasingly investor-friendly approach in its regulations and opinions.

[74] *See Recommendations*, *supra* note 62.

[75] *See* Lucian Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999) (emphasizing that dispersed ownership structures are unstable in jurisdictions allowing high private benefits of control, as they attract raiders interested in grabbing control to then expropriate the minority).

[76] *See* Gilson & Gordon, *supra* note 66.

[77] The statute now clearly provides that shareholder agreements regulating the acquisition and sale of shares, preemptive rights, voting rights, or corporate control are binding upon the company when duly filed in its headquarters, and that director votes in violation of a properly filed shareholder agreement should not even be counted. While this provides statutory support for the private initiative, and therefore may be seen as inconsistent with regulatory dualism as a strategic response to the Olson problem, the statute was adopted only after experience with the New Market and with respect to a technique – shareholder agreements – that were of practical significance largely for New Market companies. Thus, here the statute simply provided support for the regulatory dualism strategy.

those in other segments.[78] This is so because shareholder agreements can effectively prevent a hostile bidder from acquiring control even in the absence of a controlling shareholder. An account of the first (and, to date, only) hostile takeover attempt in Brazil in three decades demonstrates how shareholder agreements function to prevent an outside firm from acquiring control.[79]

In early 2007, processed food company Sadia, a family-controlled company, launched an unsolicited offer for its competitor Perdigão, a New Market firm, at a 35% premium over market price, as required under the target's bylaws. Seven pension funds accounting for 48% of Perdigão's stock were party to a shareholder agreement, which required coordination in the sale of their shares, which allowed them to quickly coordinate a joint response to Sadia's bid. Little more than 24 hours after the offer's announcement, the parties to the Perdigão shareholder agreement -- plus Weg S.A., a 5% holder and Perdigão's own pension fund – issued a press release summarily rejecting the takeover proposal. After increasing its bid once, to no avail, Sadia eventually withdrew its offer due to a lack of shareholder interest.[80]

As Perdigão illustrates, shareholder agreements in Brazil have enabled some firms to maintain an intermediate level of shareholder distribution between a single controlling shareholder on the one hand and, on the other, widely-dispersed ownership. Multi-party shareholders agreements can, under certain conditions, help reduce agency costs by combining shareholder oversight of management with the absence of a single dominant shareholder that could easily expropriate the minority without peer supervision. As well, a coalition of blockholders may not only prevent an outsider from accumulating control, but also provide a check on self-dealing by any shareholder that has operating responsibility. Shared control arrangements therefore have some promise as a pre-commitment mechanism to avoid the extraction of private benefits of control in countries with insufficient legal protection against affiliate transactions, as is the case of Brazil.[81]

As such, the combination of New Market rules and shareholder agreements can serve to simultaneously protect blockholders from each other, small holders from the

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[78] Érica Gorga, *Changing the Paradigm of Stock Ownership from Concentrated Towards Dispersed Ownership? Evidence from Brazil and Consequences for Emerging Countries*, 29 NW. J. INT'L L. & BUS. 439, 474 (noting that approximately 66% of a sample of 84 companies listed on the premium listing standards, lacking a majority shareholder and having a shareholder agreement are listed on the New Market).

[79] *Id.*, at 460 (noting that there 1970s and 1980s had seen the only two previous hostile takeovers in Brazilian history).

[80] Ironically, Sadia experienced heavy losses due to derivatives exposure in 2008, and was ultimately acquired by Perdigão through a friendly merger in 2009.

[81] For a study modeling the insight that several large shareholders could be an efficient ownership pattern for closely-held companies under certain circumstances, *see* Morten Bennedsen & Daniel Wolfenzon, *The Balance of Power in Closely Held Corporations*, J. FIN. ECON. 58 (2000) (arguing for "control dilution as a mechanism to reduce control diversion"). Bennedsen & Wolfenzon's model is based on closely held companies and assumes strict restrictions on the transferability of shares, a condition which is not met by many, if not most, shareholders agreements of Brazilian public companies. *See also,* Julian Franks & Colin Mayer, *Ownership and Control of German Corporations*, 14 REV. FIN. STUD. 943 (2001) (finding that blockholders in German firms effectively discipline management and extract low private benefits of control).

blockholders,[82] and the corporation from a raider who would eliminate the protective balance provided by the blockholders. So long as the blockholder parties to a shareholder agreement are independent of each other, the ability of the controlling coalition to consistently realize private benefits of control are constrained by collective action problems and by the difficulty of agreeing upon and contracting over expropriation methods and levels. Although many of the existing shareholder agreements are among related parties alone, raising concerns that they effectively create a potentially opportunistic controlling coalition, others arguably exhibit independence.

2. Mandatory Bid Rule

The New Market tag-along rights protect public investors from a transfer to a new controlling shareholder intending to extract higher private benefits of control by allowing the minority a presumably fair exit – that is, at the same price per share paid for the controlling block. However, such tag-along rights do not prevent a raider from accumulating a substantial stake in a widely held firm by buying shares in the market to ensure control or substantial board representation under Brazilian law.[83] This is in part the same problem at which shareholder agreements are directed. But not all firms have a group of large shareholders sufficient to support protection by a shareholder agreement against an outsider's accumulation of control.

To respond to this exposure, New Market firms began including mandatory bid rules in their bylaws,[84] which obligate a shareholder who accumulates a specified ownership percentage to make a bid for the rest of the outstanding shares at a designated price. According to the Brazilian Institute for Corporate Governance, all but three of the new firms going public from 2004 through September 2007 had adopted some form of mandatory bid rule, with triggers generally ranging from 10 to 35% of the company's shares.[85] Although by itself a mandatory bid provision is consistent with protecting a

[82] Unlike a single controlling shareholder or an affiliated controlling group, unrelated blockholders face coordination problems in expropriating minority shareholders and dividing the respective proceeds, as they are unable to write legal contracts to that effect. *See* Armando Gomes & Walter Novaes, *Multiple Large Shareholders in Corporate Governance* (1999), available at http://finance.wharton.upenn.edu/~rlwctr/papers/9905.pdf for a model predicting that bargaining problems among multiple large shareholders protect minority shareholders of closely-held corporations.

[83] Since its enactment, the Corporations Law has permitted holders of at least 10% of the company's common shares to demand the use of cumulative voting in director elections, although studies have showed that this right is rarely exercised in practice. *See*, *e.g.*, Bernard Black, Antonio Gledson de Carvalho & Erica Gorga, *An Overview of Brazilian Corporate Governance* (2008), available at http://ssrn.com/abstract=1003059. Moreover, since the 2001 amendments, the Corporations Law also allows holders of 15% of the company's common shares, or 10% of the company's preferred shares, to separately appoint a board member. Nevertheless, scholars have criticized the latter appointment rights as ineffective due to draconian liability levels imposed on shareholders and their appointees for the use of this right. *See* Bernard Black, *Strengthening Brazil's Securities Markets*, REVISTA DE DIREITO MERCANTIL, ECONÔMICO E FINANCEIRO (2001), available at http://ssrn.com/abstract=247673.

[84] Brazilian practitioners and scholars alike refer to these mandatory bid clauses as "poison pills," thus borrowing the terminology used to describe certain U.S. takeover defenses that allow the board of directors to unilaterally ward off a hostile takeover attempt by issuing securities to the remaining shareholders that dilute the position of the acquirer. We will refrain from using this term for purposes of the paper as we find this analogy inaccurate and, therefore, unhelpful.

[85] Lucia Rebouças & Nelson Rocco, *Conceitos Básicos de Governança Se Tornam Consensos de Mercado*, GAZETA MERCANTIL, May 19, 2008.

company without a controlling shareholder from the acquisition of control by a predatory third party, some of their ancillary provisions raise concerns about entrenchment.

Mandatory bid rules adopted by New Market firms typically specify that the purchase be made at a designated premium.[86] While modest premiums could be justified based on market inefficiency and collective action problems in coercive tender offers, mandatory premiums close to 50% above the firm's 52-week high price, as adopted by some companies, are all but prohibitive, and effectively serve as a takeover shield. The problem posed by these exorbitant premium requirements is reinforced by the fact that, in many companies, such clauses are dead hand devices – that is, neither shareholders nor the boards can alter their content without first offering to buy out the remaining shareholders under the existing criteria.[87] In response to these developments, the Brazilian Securities and Exchange Commission (*Comissão de Valores Mobiliários* - CVM) has recently asserted that "immutable" provisions in firm bylaws are invalid under Brazilian law, and signaled that it will not prosecute shareholders that vote to amend or suppress the mandatory bid requirements without launching such a tender offer.[88]

The ongoing revision process of New Market regulations highlights the complementarity between the segment's listing standards and the firms' shareholder agreements and bylaws.[89] The New Market's Working Group in charge of revisiting the listing standards has rebuffed proposals to undermine the force of shareholder agreements despite protests from corporate governance advocates,[90] and seems to favor a new listing standard imposing mandatory bid requirements (or tag-along rights) upon the acquisition of a large but not majority stake in the firm. This implies that the firms' contractual provisions have, at least to a degree, served to fill out perceived gaps in investor protection in the existing statutory and listing rules.

D. One Judiciary for Two Regulatory Regimes

A problem with regulatory dualism -- at least when deployed within a single country, as in Brazil, rather than across multiple states, as in the United States and European Union approaches described below -- is that, in principle, both of the regulatory regimes must ultimately be enforced by the same national judiciary. And a weak judiciary is a characteristic problem in developing countries. Thus, the question arises

[86] S. Wade Angus & Mariana Pargendler, *Opportunities and Challenges for Foreign Private Equity Investors in Brazil* 63, 73, *in* INTERNATIONAL BUSINESS TRANSACTIONS WITH BRAZIL (Beatriz Franco et al. eds., 2008) (citing that Renner, the New Market company with the most widely dispersed shareholdings, requires a 20% premium over its 90-day average price, while Embraer, an aircraft manufacturer, requires a premium of 50% over the greater of its peak price in the previous 52 weeks or 14.5 times the company's EBITDA).

[87] *See* Gorga, *supra* note 78 (finding that, out of a sample of 84 companies traded on the premium listing standards and that do not have a clear controlling shareholder, 25 had immutable "poison pills".)

[88] CVM Advisory Opinion 36/2009 (June 23, 2009).

[89] For a broader discussion of the Exchange's effort to revise the New Market listing standards, *see* Part VI below.

[90] The Brazilian Institute for Corporate Governance, among others, has publicly promoted the creation of a New Market listing requirement eliminating the binding effect of shareholder agreements on directors' votes as allowed under current law. Graziella Valenti, *Novo Mercado Atinge 95 Companhias Listadas*: *Novo Mercado Tem Desafio para Evoluir*, VALOR ECONÔMICO, Apr. 7, 2008.

whether two regulatory regimes can be made significantly different if they both depend on the same enforcement regime.

In Brazil, the New Market and Level 2 attempt to avoid the enforcement difficulties associated with an ineffective judiciary[91] through the provision of mandatory and institutionalized arbitration for internal affairs disputes. Here, as elsewhere, the conventional advantages of arbitration over public judicial procedures apply. Arbitration procedures are believed to be faster, as well as more confidential and technical (and thus less subject to political pressures or corruption), than a typical judicial lawsuit in Brazil.[92]

Nonetheless, arbitration procedures generally suffer from important limitations with respect to corporate law and complex commercial disputes. The structure of arbitral tribunals, which are not bound by precedents and are typically chosen by the parties after a dispute has arisen, produces a different incentive structure and decision process than those of courts. For instance, arbitral panels have an infamous tendency to "split the baby" and find a mutually acceptable, even if unprincipled, solution to the dispute in question. Public courts, in contrast, can perform better in holding parties to their incentives for performance ex ante, a fundamental function of commercial and corporate agreements.[93] In a study covering more than 2,800 large commercial contracts by publicly traded U.S. corporations, Professors Eisenberg and Miller found that sophisticated commercial parties in the U.S. commonly opt for public courts (especially those of New York) rather than arbitral tribunals in their forum selection clauses.[94] In developing countries like Brazil, however, with weak public commercial courts, arbitration may be the only domestic means of addressing the enforcement problem.

The New Market's approach to arbitration is cleverly designed to mitigate arbitration's weaknesses. The arbitration proceedings are managed by a permanent Market Arbitration Panel established under the auspices of the São Paulo Stock Exchange,[95] thus adopting a structure that resembles a public court. For example, the Panel is required to periodically publish the content of the substantive decisions and the

[91] Brazil's judiciary is famously slow and lacks the expertise in complex commercial and corporate law matters. According to the most recent cross-country comparison by the 'Doing Business' division of the World Bank, Brazil ranks as 100 out of 181 economies with respect to the ease of enforcing commercial contracts. *See* Doing Business 2009 – Brazil, available at http://www.doingbusiness.org/ExploreEconomies/?economyid=28.

[92] Public courts must ultimately enforce arbitration awards in the absence of voluntary compliance by the losing party, which reintroduces concerns about judicial effectiveness, but the procedure for the enforcement of arbitration awards is much simpler than the initial determination of a violation, and is subject to a limited scope of review.

[93] Jens Dammann & Henry Hansmann, *Globalizing Commercial Litigation*, 94 CORNELL L. REV. 34 (2008).

[94] Theodore Eisenberg & Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in Publicly-Held Companies*, 56 DEPAUL L. REV. 335 (2007).

[95] The involvement of the São Paulo Stock Exchange in the New Market arbitration process is not trivial. The board of directors of BM&F Bovespa is responsible for appointing thirty arbitrators with renowned capital market expertise to compose the Panel, and the applicable regulations provide that the parties should preferably, although not necessarily, appoint arbitrators who are members of the Panel. Thus, the reputations of prominent individuals are placed behind the arbitration procedure. In addition, before the award is made final, the Arbitral Tribunal needs to submit a draft to the Chairman or Vice-Chairman of the Panel, who, without interfering with the arbitrators' judgment, may propose changes to the formal aspects of the award and draw attention to other substantive aspects of the dispute. *See* Market Arbitration Panel Regulation, Sections 7.8 and 9.2.1.

names of the respective arbitrators.[96] This ensures a channel of accountability to, and pressure from, market participants -- although the names and other identifying information about the parties and their lawyers are expressly exempt from disclosure requirements, which compromises somewhat the system's transparency. The Panel regulations also provide that arbitrators may take the Panel's precedents into account in their decision making process.[97] Moreover, because the arbitration procedure is administered by the São Paulo Stock Exchange – an institution having a major stake in the integrity of the New Market – the potential for arbitral decisions to disregard policy considerations and their ex ante impact on other actors' incentives is also reduced, though not eliminated. The Panel regulations in fact allow the parties to jointly authorize the Arbitral Tribunal to decide the dispute based on equity considerations.[98]

The very structure of the New Market listing rules also facilitates their enforcement by the stock exchange, arbitrators, and courts. The rules tend to be both conceptually simple and easily verifiable. Most important, they are rule-like rather than standard-like: they do not require an exercise of substantive judgment as would, for example, the imposition of a fiduciary duty.[99] In addition, New Market firms focus heavily on charter provisions and shareholder agreements that have a strongly contractual character, and that have a similarly rule-like structure more easily enforced by private lawsuit. They consequently do not require activism on the part of public officials to be effective, nor do they require the existence of a well-established body of jurisprudence giving concrete meaning to vague legal standards. Moreover, the shareholder rights involved -- such as access to information and voting rights -- can be enforced by a simple injunction without requiring any particular creativity, or even much knowledge or judgment, on the part of the enforcing arbitrator or judge.

No arbitration decisions have been reported to date. The scarcity of complaints may indicate a high degree of compliance and investor comfort with the governance of New Market firms. However, the Brazilian judiciary also experienced a similar dearth of complaints concerning corporate governance matters for many years, without warranting a conclusion about the exemplary behavior of Brazilian companies with respect to minority protection.[100] Minority shareholders may simply have recognized a lost cause when they saw one.

All in all, the New Market is making a plausible effort at leveraging its arbitration panel to create an alternative enforcement solution for the new, more rigorous market regime. Whether the balance struck in the New Market's enforcement mechanism is effective will depend on the New Market's actual operation, to which we now turn.

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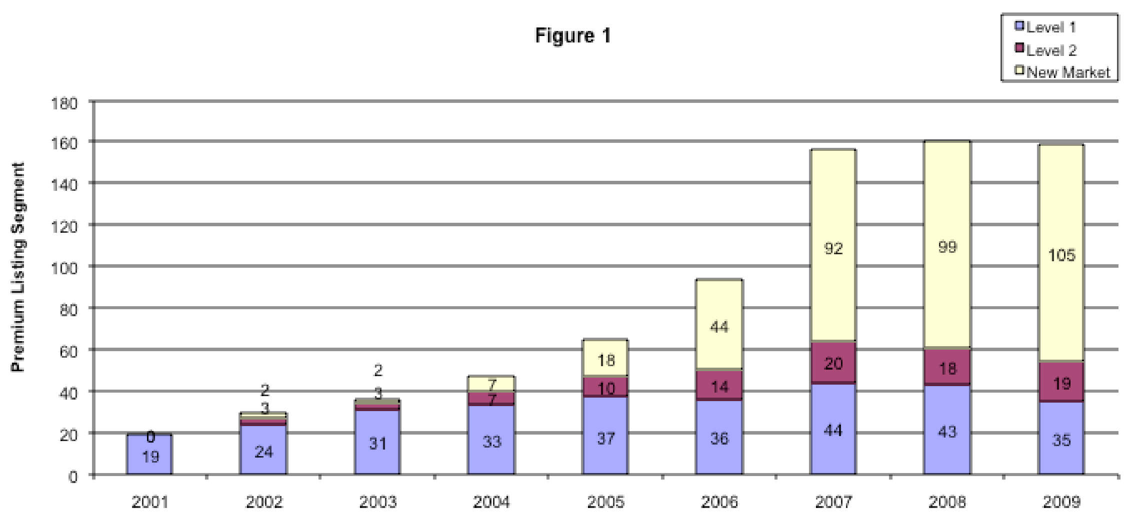
[96] Market Arbitration Panel Regulation, Section 9.13.
[97] *Id*.
[98] Market Arbitration Panel Regulation, Section 7.12.7.
[99] There is a recent trend towards employing complementary standards to prevent listed firms from employing alternative transaction structures to circumvent narrow rules. *See* note 64 *supra* and accompanying text. For discussion of the less demanding judicial role in applying rules rather than standards, see Alan Schwartz and Robert E. Scott, *Contract Theory and the Limits of Contract Law,* 113 YALE L.J. 541, 601–05 (2003).
[100] *See* Paulo Cezar Aragão, *A CVM em Juízo*: *Limites e Possibilidades*, 89 REVISTA DO ADVOGADO 38, 40 (2006) (noting that in the more than 30 years of authority of the 1940 Corporations Law, there was only one judicial lawsuit on the duties and liabilities of managers of Brazilian corporations).

E. Experience with the New Market

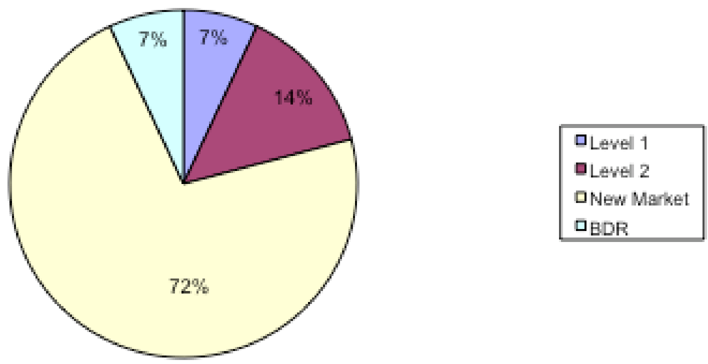
The New Market eventually became the highlight of Bovespa's premium listing segments, but that success developed only over time. From its official launch in December 2000 until 2002, the New Market had no listings, and did not become a mainstream option for IPOs until 2004. The slow start was due in no small part to the fragility of equity markets worldwide, and in particular the disappearance of IPOs following the burst of the dot-com bubble and the U.S. corporate governance scandals in the early 2000s. Because the New Market was primarily designed for new public firms, the dearth of new IPOs was especially damaging. It was not until 2005 that the market for Brazilian IPOs opened in a reliable fashion, which resulted in the New Market segment experiencing a boom in new listings

As a result, during the 2000 through 2004 period the São Paulo Stock Exchange focused on persuading existing firms to join Levels 1 and 2, which were less demanding and did not directly constrain existing controlling shareholders. As early as 2001, 15 firms that previously traded on the traditional segment had moved to a Level 1 listing. Figures 1 and 2 below show the aggregate number of firms listed in the different premium segments and the distributions of IPOs per segment from 2001 through 2009.



Source: BM&F Bovespa

Figure 2
IPOs per Segment (2004 - 2009)



Source: BM&F Bovespa

As anticipated by its founders, a significant majority of New Market listings took place in connection with the firms' IPOs – that is, at the point in time in which the incentives of controlling shareholders to make corporate governance concessions are at their maximum in order to reduce their cost of capital. More important, over 72% of all Brazilian IPOs were listed on the New Market, and all new Brazilian listings since 2004 took place on one of the premium listing segments.[101] Indeed, the National Association of Investment Banks used its self-regulatory authority to prevent its members from underwriting new offers which did not, at a minimum, satisfy a Level 1 listing.[102] Of these, the overwhelming majority of new registrants opted for the New Market.[103]

For most already-listed firms, the existence of a substantial amount of non-voting preferred shares held by minority shareholders was an impediment to migration to the New Market. Out of more than 100 firms that listed on the New Market between 2002 and 2009, only approximately 20% had previously been listed on the traditional segment. This is so even though the Brazilian Securities and Exchange Commission has permitted "Pareto superior" reorganizations that eliminate the non-voting shares, with the efficiency gains shared between controlling and noncontrolling shareholders. In effect, these reorganizations compensate the controlling shareholders for giving up rights to

[101] *See* www.bmfbovespa.com.br.
[102] ANBID Self-Regulatory Code for Public Offerings for the Distribution or Acquisition of Securities, Art. 6.
[103] Moreover, many of the recent IPOs that took place outside of the New Market did so due to regulatory restrictions on foreign control that prevented firms from issuing only voting shares without governmental approval. These firms generally opted for a Level 1 or 2 listings and committed in their prospectus to a New Market migration once the requisite authorizations were obtained.

expropriate the noncontrolling shareholders.[104] In Brazil, this is accomplished by permitting controlling shareholders to extract a premium upon the conversion of preferred shares into common shares in anticipation of a migration to the New Market, so long as the minority shareholders separately approve the transaction.[105] Indeed, at least four firms have approved the conversion of preferred shares to common shares at premiums to common shareholders ranging from 9% to 28%, but substantial transaction costs and information asymmetries hinder the occurrence of additional efficient migrations.[106]

But this is not the entire story. Although the difficulties in unwinding "leveraged" governance structures may be holding back firms listed in other premium standards from listing on the New Market, this is not the case for existing public companies moving to Levels 1 or 2. Nonetheless, the overwhelming majority of companies listed in the traditional segment at the time of the launch of Bovespa's premium standards have not migrated even to Level 1 or Level 2, and have not otherwise made meaningful voluntary governance concessions, such as granting tag-along rights beyond the regulatory minimums. The obvious explanation is that they lack any incentive to make concessions. Many of these firms went public in the distant past (and often for tax reasons), and have little interest in giving up their lax regulatory treatment for the sake of better access to public markets. Nevertheless, despite their limited contribution to market liquidity and trading volume, they still represent a majority of the formally publicly traded companies in Brazil[107] – hence their clout in opposing comprehensive legal reform and the importance of the fact that they were allowed to remain on the traditional segment. Other old firms are among the largest and most successful Brazilian corporations – the so-called "blue chips" – which, due to their size and track record, have traditionally had privileged access to local and foreign capital markets and other financing sources. They too have found it unnecessary to commit to more stringent governance levels, and have at most migrated to Level 1.

[104] These reorganizations are examples of the "efficient restructurings" discussed in Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439, 461 (2001). Hansmann and Kraakman note that efficient restructurings require that the controlling shareholders be able to extract the capitalized value of private benefits of control when opting for a superior corporate governance regime. Efficient restructurings, they argue, can be an antidote to the path-dependent nature of corporate ownership and governance identified by Bebchuk and Roe. *See* Bebchuk & Roe, *supra* note 75.

[105] CVM Advisory Opinion 34/2006. The BM&F Bovespa Working Group has also refrained from proposing any limits to conversion ratios of non-voting shares to voting shares prior to a New Market migration. In a highly publicized transaction involving a major Brazilian telecom, minority shareholders rejected a proposal to migrate from the traditional segment to the New Market at conversion ratios by which common shares would be worth 2.6 times more than preferred shares. *Oi!, Brazils' Shareholding Elite Receives a Black Eye From the Regulator*, THE ECONOMIST, Aug. 29, 2006.

[106] In addition, at least a handful of the firms that migrated to the New Market from the traditional segment had as a shareholder the investment arm of Brazil's National Development Bank (BNDESPar), an early and vocal supporter of the New Market – implying that the new segment may have been embraced in these cases owing to factors other than the invisible hand of the market.

[107] As of November 2009, the firms listed on Bovespa's premium standards represented only about 37% of the exchange's total listed companies, but approximately 78% of its trading volume. The New Market accounted for more than 24% of the total number of firms listed on the exchange and for nearly 35% of its trading. Source: BM&F Bovespa.

The New Market contributed to changing the ownership structure of Brazilian companies by eliminating, for listed companies, the previously pervasive wedge between voting and cash-flow rights. The result was to increase the cost of voting shares for a controlling shareholder. New Market firms therefore have a significantly higher degree of dispersion of voting shares than those listed in other segments.[108] Moreover, the New Market also encouraged the rise of the few truly widely held companies in Brazil, a phenomenon that was widely acclaimed by both local media and scholars[109]

Yet despite the emergence of a few widely-held companies and the evolution toward intermediate ownership structures based on blockholdings, it is easy to overstate the extent of the shift toward ownership dispersion in the New Market. First, dispersed ownership is often too loosely defined. Brazilian commentators and New Market regulators define "dispersed control" as the absence of any individual shareholder or group holding at least 50% of the company's voting stock.[110] Hence, many companies that are labeled as having dispersed ownership structures in Brazil actually have a major blockholder that would be treated as a controlling owner in other jurisdictions.[111] Moreover, shareholder agreements and overly rigid mandatory bid rules allow small groups of major shareholders to exercise uncontested control even though no single shareholder holds a majority of voting shares. [112]

Although the New Market is by no means the only factor that contributed to the capital market boom in Brazil in recent years,[113] the expansion of Brazilian capital markets following the New Market's launch was remarkable. In 2007, Brazil was the third most active IPO market in the world, after China and the U.S., and was responsible for 10% of the volume of such offerings worldwide.[114] By mid 2008, Brazil's stock market capitalization for the first time equaled its GDP,[115] and the New Market alone had 100 listings. Just like its counterparts around the world, Brazil's capital markets suffered

[108] *See* Gorga, *supra* note 78.
[109] Id.; for media accounts, see, e.g., Vinicius Neder, *Corporações com Capital Aberto e Controle Disperso Influem Cultura Empresarial*, JORNAL DO COMÉRCIO, Mar. 13, 2006; Vanessa Adachi & Catherine Vieira, *Pulverização do Controle Acionário Cria Grupo de Executivos Superpoderosos*, VALOR ECONÔMICO, Mar. 13, 2006.
[110] Novo Mercado Listing Rules (defining "diffuse control" as the control exerted by a shareholder who holds less than 50% of the company's capital stock). *See also,* Gorga *supra* note 78 at 27.
[111] For example the law-and-finance literature adopts a substantially lower threshold to ascertain the existence of a controlling shareholder. *See, e.g.*, La Porta et al., *Corporate Ownership around the World*, 54 J. FIN. 471, 491 (1999) (using a 10% threshold to determine control).
[112] As of 2008, Level 1 firms (where many of the old, traditional Brazilian firms are listed) still had on average slightly more widely distributed shareholdings as a percentage of total capital than New Market companies – though this is not the case if one counts only voting shares. *See* Gorga *supra* note 78, at 85-6 (for comparative tables on ownership structure of New Market and Level 1 corporations).
[113] Improvements in domestic macroeconomic conditions, including the decline in interest rates of Brazilian public bonds, and booming international financial markets were also key to the renaissance in Brazil's capital markets starting in 2004. Previously, the combination of high inflation, staggering interest rates, and unstable economic policy had created an unsuitable environment that deterred Brazil's capital market development. *See, e.g.,* Angus & Pargendler, *supra* note 86.
[114] Ernst & Young, *Growth During Economic Uncertainty: Global IPO Trends Report* (2008). Brazil raised $27.3 billion in IPOs, compared to $34.2 billion in the U.S. and $66 billion in China. *Id.*
[115] Fabricio Vieira, *Valor das Empresas na Bolsa Alcança o PIB*, Folha de São Paulo (June 16, 2008). In 1996, Brazil's stock market capitalization equaled 37% of GDP and in 2000 37% of GDP. *Id.*

a significant setback beginning in the second half of 2008, but they have also been among the first to recover from the global financial downturn.[116] The São Paulo Stock Exchange was home to the largest IPO worldwide through the first three quarters of 2009, which, at approximately $8 billion, was the largest in its history.[117] The New Market's apparent success to date has not gone unnoticed by stock exchanges in other developing countries. Major stock exchanges in India and the Philippines are drawing on Brazil's experiment as they design their own corporate governance listing standards.[118]

III. Other Examples of Regulatory Dualism in Corporate Law

Brazil's New Market offers a paradigmatic example of regulatory dualism as a self-conscious strategy in which the reformist regulatory regime was deliberately implemented to circumvent a strong version of the Olson problem. But there are other prominent examples of regulatory dualism that serve to diffuse political opposition from existing elites. Because the Olson problem is pervasive, and in no way limited to developing countries,[119] regulatory dualism has broad application as a means of facilitating economic growth. Nor is regulatory dualism wholly a recent to legal development.[120] The medieval law merchant was arguably an example, in which a trans-national body of commercial law -- distinct from the general law of the era, and with its own separate courts -- arose among merchants across Europe.[121]

We examine here three further examples of regulatory dualism in the reform of corporate and capital markets law: one similar to Brazil's except for its conspicuous

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[116] Recent empirical work suggests that better corporate governance standards contributed to the stock prices of companies listed on the São Paulo Exchange premium listing segments (Level 1, Level 2 and the New Market) being less sensitive to changes in the market than the price of stocks listed on the traditional segment and, in general having lower volatility. Pablo Rogers & Jose Roberto Securato, *Corporate Governance and Volatility in the Capital Markets: Brazil Case Study*, 7 J. CORP. OWNERSHIP & CONTROL 43 (2009). These findings, however, precede the 2008 financial crisis, a time in which the share prices of firms listed on the New Market fell more than those of companies listed on the traditional segment. The stock prices of New Market firms have since then largely recovered.

[117] Lynn Cowan & Rogerio Jelmayer, *Year's Biggest IPOS Make Debuts*, WALL ST. J., Oct. 8, 2009. Banco Santander S.A., as other banks going public in recent years, opted for a Level 2 listing.

[118] *Inspiration from the East: Encouraged by the Novo Mercado's Success, the Philippines and India Create Special Listing Tiers in Their Own Stock Exchanges*, 72 CAPITAL ABERTO (Aug. 2009).

[119] OLSON, *supra* note 3, at 3 (citing Britain after World War II as the most notable case of relative decline owing to the harmful influence of powerful interest groups).

[120] TULIO ASCARELLI, PANORAMA DO DIREITO COMERCIAL (1947) (noting that duality in private law, in which a new legal regime emerges parallel to the traditional system, only to later achieve universal application, is pervasive in legal evolution).

[121] *See, e.g.*, A. CLAIRE CUTLER, PRIVATE POWER AND GLOBAL AUTHORITY (2003) (arguing that "medieval law merchant supported a predominantly private commercial order, generating merchant laws and institutions that operated outside the local political economy of the period"); Francesco Galgano, *Lex Mercatoria* (2001) (describing the history of the lex mercatoria as a body of law directly created and applied by the merchant class, without the mediation of general politics); ASCARELLI, *supra* note 120 (noting that the economic demands relating to the dynamism of the emerging commerce demanded a departure from the civil law principles, which continued to govern agrarian relations). *But see* Stephen E. Sachs, *From St. Ives to Cyberspace: The Modern Distortion of the Medieval 'Law Merchant,'* 21 AM. U. INT'L L. REV. 685 (2006) (arguing that, contrary to the conventional view, medieval merchants were largely subject to local laws and customs, which varied substantially).

failure, and two others that differ markedly from the Brazilian approach in the source of authority for the reformist regime.

A. The Frankfurt Neuer Markt

Although Germany had vigorous equity markets in the early twentieth century, by the end of World War II its economy became largely dependent on bank financing.[122] From 1965 to 1996, only 434 companies went public on the Frankfurt Deutsche Börse, Germany's principal stock exchange.[123] Germany's publicly traded corporations were mostly large, mature firms, displaying an average 55 years of existence by the time of their IPO.[124]

While the bank-centered corporate finance regime served Germany well in the immediate post-war period, a wave of bankruptcies in the 1980s focused attention on the highly leveraged capital structure of German firms and the perceived "equity gap" compared to other developed economies.[125] In 1987, the Frankfurt Stock Exchange decided to address this problem by lowering entry barriers to equity markets. The compromise solution was to create, in addition to the existing Official Market (*Amtlicher Handel*) and the Unregulated Market (*Freiverkehr*), an intermediate Regulated Market (*Geregelter Markt*) subject to less stringent requirements than the Official Market in order to accommodate the needs of small and mid-cap firms.[126] The Regulated Market, however, failed to attract a significant number of listings and afford sufficient liquidity.[127]

Ten years later, to halt the flight of German new listings to the NASDAQ, the Frankfurt Stock Exchange in May 1997 created yet another listing segment. The Neuer Markt targeted high-growth firms in a period in which European stock exchanges were competing to provide exit opportunities to venture capitalists.[128] The need to find financing alternatives for start-ups was especially acute in Germany, since banks had

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[122] Eric Nowak, *Investor Protection and Capital Market Regulation in Germany* 426, *in* THE GERMAN FINANCIAL SYSTEM (Jan Pieter Krahnen & Reinhard H. Schmidt eds., 2004) (noting that prior to World War I, Germany's stock markets boasted nearly 1,200 listed companies compared to the approximately 600 firms listed on the New York Stock Exchange). *See* Franks et. al., *supra* note 2 (describing German stock markets prior to the mid-20th century)._

[123] MB Associados, *supra* note 10 (citing Simon Johnson, *Does Investor Protection Matter? Evidence from Germany's Neuer Markt*, MIT Manuscript, 1999).

[124] John Schmid, *Menu is Meager at 'New' Exchanges*, INT'L. HERALD TRIB., Mar. 12, 2003.

[125] Hans-Peter Burghof & Adrian Hunger, Access to Stock Markets for Small and Medium Sized Growth Firms: The Temporary Success and Ultimate Failure of Germany's Neuer Markt (2003) at 2, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=497404.

[126] *Id.* at 3.

[127] *Id.* at 4.

[128] The London Stock Exchange inaugurated the trend with the launch of the Alternative Investment Market (AIM) in 1995, and was followed by the Belgium-based pan-European Easdaq and Paris Bourse's Nouveau Marché in 2006. *See* Gail Edmonson & Heidi Dawley, *Europe Finally Wakes Up to High-Tech Startups*: *Its Young Companies Begin to Attract the Capital They Desperately Need*, BUSINESSWEEK, May 26, 1997. According to the Neuer Markt Rules and Regulations, "issuers are, in particular, innovative enterprises which develop new sales markets, utilize new methods of, for example, procurement, production or distribution, or offer new products and/or services, and whose activities can be expected to generate high turnover and profits in the future."

come under increasing criticism for their unwillingness to finance high-tech firms.[129] While its predecessors aimed at attracting entrants by exempting young firms from the most stringent requirements for a mainstream listing, the Neuer Markt took the opposite stance. Like Brazil's New Market, the Neuer Markt was more, not less, regulated than Germany's official segment, whose requirements were left untouched by this new initiative.[130] As La Porta et al. have recognized, the Olson problem was a driving force behind Germany's approach to regulatory dualism through the Neuer Markt, as established and bank-dominated German firms were generally hostile to changes in their legal regime.[131] In short, the Neuer Markt was a clear example of regulatory dualism.

Neuer Markt firms were required to sell only common, rather than non-voting preferred shares; ensure a 25% minimum free-float; report earnings quarterly in English and German, in accordance with IAS or U.S. GAAP; provide for a lock-up prohibiting sales by the original shareholders for six months after the initial offering; obtain two sponsors responsible for the liquidity and tradability of the shares; and raise at least 50% of the offer's value in new equity. Only high-growth firms having at least a three-year track record and a minimum of €1.5 million in net equity were eligible for a Neuer Markt listing.[132] The Deutsche Börse could deny a Neuer Markt application despite a firm's compliance with the segment's formal requirements when it deemed that the admission would be "contrary to the protection of the interests of the investors" or "lead to damage of significant public interests."[133] An arbitration panel was organized by the Deutsche Börse to decide disputes about Neuer Markt admission and enforcement decisions.[134]

Notwithstanding the initial skepticism about an over-regulatory approach,[135] the Neuer Markt was quite successful in its first years. At its peak in early 2000 it had more than 300 listings and a market capitalization exceeding $400 billion.[136] Moreover, the Neuer Markt's focus on individual investors helped to more than double the equity ownership of German adults over a three-year period.[137] The media credited the segment for overriding Germany's legendary lack of an "equity culture."[138]

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[129] Sigurt Vitols, *Frankfurt's Neuer Markt and the IPO Explosion: Is Germany on the Road to Silicon Valley?*, 30 ECON. & SOC'Y 553, 554 (2001).
[130] *See, e.g.*, Erik Theissen, *Organized Equity Markets* at 140, *in* THE GERMAN FINANCIAL SYSTEM (Jan Pieter Krahnen & Reinhard H. Schmidt eds., 2004)
[131] La Porta et al., *Investor Protection and Corporate Governance*, *supra* note 2 (noting that "captains of German industry have accepted [the Neuer Markt] because their firms were not directly affected").
[132] Neuer Markt Rules and Regulations.
[133] *Id.*, § 2.2.2(2). The listing committee rejected about 20% of the applicants based on a "subjective" approach. *See* Stewart Fleming, *The Neuer Markt's Wild Ride*, 42 INSTITUTIONAL INVESTOR (1999).
[134] Neuer Markt Rules and Regulations, § 2.1.6.
[135] Sharon Reier, *Full Disclosure*: *Where (Outside the U.S.) to Find Company Data: On the Continent, a Hodgepodge of Local Standards and Laws*, INT'L HERALD TRIB., Nov. 6, 1999 (citing early remarks by market participants that the Neuer Markt would "die in beauty" as the rigorous standards would discourage listings).
[136] Mark Lander, German Technology Stock Market to Be Dissolved, N.Y. TIMES, Sept. 27, 2002.
[137] *See* Vanessa Fuhrmans, *Playing by the Rules*: *How Neuer Markt Gets Respect*, WALL ST. J., Aug. 21, 2000. The percentage of German adults holding shares soared from approximately 9% in 1997 to 20% in 2000. *Id.*
[138] *Neuer Markt's Global Ambitions*, Marketwatch, June 23, 1999.

The Neuer Markt became the envy of its European competitors, giving rise to the rapid adoption of regulatory dualism in other countries.[139] High-growth listing segments in Amsterdam, Brussels, Paris, and Milan attempted to emulate at least some of the Neuer Markt's requirements.[140] A few years later, Europe would have some 30 special listing segments for small-cap companies.[141] In addition, the Frankfurt Stock Exchange sought to reproduce the Neuer Markt in a 1999 experiment by creating the SMAX, a premium listing standard aimed at small and medium-cap firms in the Old Economy which contained most of the Neuer Markt's transparency requirements.[142]

The Neuer Markt's rigorous requirements were only one component of the segment's success. Another critical element was the general optimism about the New Economy, which boosted the segment's share price performance. From the onset, the Deutsche Börse emphasized the segment's flagship index as a marketing device.[143] In the three years after its launch, the Neuer Markt index rose nearly tenfold, which helped lure additional investors.[144]

The Neuer Markt flourished so long as its two pillars – corporate governance integrity and confidence in the New Economy – remained intact. The burst of the dot.com bubble in mid 2000 unsettled both foundations. The Neuer Markt stock index eventually lost 96% of its peak value. But market corrections based on the expected performance of high-tech firms were not the only cause of the stock price decline. The Neuer Markt also witnessed an array of corporate scandals, ranging from insider trading to outright fraud, which progressively tarnished the segment's reputation.

MobilCom, whose share prices initially followed the index's ten-fold rise, was left on the brink of bankruptcy after a self-dealing scandal involving an investment vehicle owned by its founder's wife.[145] Comroad, a traffic-navigation technology firm, turned out to have fabricated nearly all of its reported revenue.[146] Internet advertiser Adpepper reduced its earnings expectations less than one month after its IPO.[147] The required sponsors for Informatec, a software company, quit after the firm made overly rosy statements about its pending contracts.[148] The founder of EM.TV, a media company, breached the mandatory lock-up requirement and sold nearly 200,000 shares within six months of the initial offering.[149] Moreover, a regulatory loophole allowing company founders to sell their shares after the initial six-month lock-up period without market disclosure consistently distorted trading in less liquid Neuer Markt firms.[150]

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[139] *La Guerre des Nouveaux Marchés D'Actions Fait Rage en Europe*, LE MONDE, Feb. 10, 1999.
[140] Fuhrmans, *supra* note 137.
[141] Schmid, *supra* note 124.
[142] Fuhrmans, *supra* note 137. Little more than one year after its launch, the SMAX featured 125 listings. *Id.*
[143] Burghof & Hunger, *supra* note 125, at 8.
[144] Brian M. Carney, *Teutonic Tailspin: A German Market's Rise and Fall*, WALL ST. J., Oct. 1, 2002.
[145] *Id.*
[146] *Id.*
[147] Edmund L. Andrews, *Think Nasdaq, Now Double the Pain*, N.Y. TIMES, Jan. 28, 2001.
[148] David Fairlamb, *Down and Out in Frankfurt: The Neuer Markt's Woes Include a Tech-Stock Slump, Management Wrangles, and Fierce Rivalry from London*, BUSINESSWEEK, Oct. 23, 2000.
[149] Andrews, *supra* note 147.
[150] *Id.*

In fact, the Neuer Markt experienced enforcement deficiencies from the outset. As of mid-2000, it had issued numerous private reprimands, but had not levied a single fine.[151] It was not until 2001 that the Deutsche Börse raised its maximum fine for individual violations tenfold to 100,000 Euros, which was still a modest amount for most companies.[152]

Lax enforcement of the existing requirements was not the only weakness of the Neuer Markt that the market crisis exposed. Revising the listing standards to address new circumstances also proved to be problematic. Because those standards were embodied in a private legal agreement between the Deutsche Börse and each listed firm, the Neuer Markt initially touted its flexibility to adjust its rules in light of changing conditions.[153] However, the seeming advantage of the Neuer Markt's private contractual character soon backfired. German courts concluded that the Neuer Markt's private law nature prevented the Deutsche Börse from unilaterally revising the listing rules without regard to the interests of issuers, thus frustrating the Exchange's attempt to automatically delist "penny stocks" following the market crash.[154]

Just as the Neuer Markt's reputation for firm quality and market integrity generated positive externalities in its first years, the proliferation of corporate scandals and the economic collapse of so many of its firms eventually undermined the credibility of the entire pool.[155] Indeed, much of the initial pressure to strengthen the existing listing requirements did not come from investors or regulators, but from some of the segment's top listed firms, which threatened to leave the segment if the exchange did not act quickly to rebuild its reputation.[156] The Neuer Markt, once a quality seal, became a "synonym for failure."[157] After significant brand damage, the Deutsche Börse discontinued the Neuer Markt altogether in 2003.[158]

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[151] Fuhrmans, *supra* note 137.

[152] *See* Neuer Markt Rules and Regulations, § 2.1.4; Jack Ewing, *The Neuer Markt Needs a Watchdog with Teeth*, BUSINESSWEEK, Jan. 8, 2001.

[153] Fuhrmans, *supra* note 137.

[154] Josef Tobien & Olaf Schick, *New Listing Regulations,* INT. FIN. L. REV. (Oct. 2001); Dewey Ballantine LLP Information Memorandum, *End of Neuer Markt* (Oct. 15, 2002).

[155] Rachel Stevenson, *Scandals and Bankruptcies Destroy Germany's* Neuer Markt, THE INDEPENDENT, Sept. 27, 2002 (citing an investor's statement that while the Neuer Markt was initially a "high-profile index," it eventually became "the last place you would want to list a business because of the negative associations."). *See also,* Coffee, *supra* note 53, at 1805 (attributing the debacle of the Neuer Markt to "the strength of the network externalities that link firms traded on the same high profile market").

[156] Neal E. Boudette & Alfred Kueppers, *Frustrated* Neuer Markt *Members Push for Tightening Listing Rules*, WALL ST. J., July 11, 2001.

[157] Lander, *supra* note 136.

[158] The elimination of the segment was part of a broader overhaul of the Frankfurt Stock Exchange listing standards. The regulatory regime remained dual, as the new listing structure was overtly based on a "one market, two standards" approach. However, the new system was arguably the reverse of a regulatory dualism strategy, with the established firms subject to the most rigorous requirements. Deutsche Börse, *Stocks and Standards: What's Changing in Deutsche Börse's Market Segments* – N.8 (2002) (noting that the "harmonization of standards governed by public law increases rule enforcement and provides legal certainty, factors which are essential to restore investor confidence"). The new entry-level General Standard is subject to federal law requirements applicable to all companies listed on the Frankfurt Stock Exchange. It is aimed at small and medium-cap firms seeking domestic investors and a cost-effective listing. The more rigorous Prime Standard incorporates, in addition to the General Standard provisions, the

The Neuer Markt also exposed the challenges associated with contractual commitments to superior investor protection. Following the dot.com burst's revelation of the legal obstacles to amendments to the Neuer Markt's rules, the German Congress passed a new statute according greater flexibility to stock exchanges to change their regulations.[159] The Deutsche Börse viewed the shift away from private agreements toward quasi-public regulation as key to the success of its new system.[160]

B. Corporate Chartering in the United States

The success of the United States in developing a strong body of investor protection law can also be understood as the fruit of regulatory dualism. To be sure, the most significant pieces of investor protection legislation in the United States, the Securities Act of 1933 and the Securities Exchange Act of 1934, are mandatory in nature and apply to all publicly traded corporations alike. But these statutes were enacted during the Great Depression following the stock market crash of 1929, in a period of a broad regulatory overhaul. That is, much of the law protecting investors in the United States emerged in a period of cataclysm -- typical of the circumstances in which, in Olson's view, the blocking power of existing elites can be overcome.

In the less cataclysmic political climate that both preceded and followed the 1930s, however, an important driver of legal evolution in the corporate arena has been regulatory dualism based on state-level corporate chartering.[161] This approach combines an "internal affairs doctrine" (according to which the laws of the state of incorporation govern the relationship between shareholders, directors, and managers) with freedom of choice as to state of incorporation without regard to the location of the firm's operations. An important advantage of this system is its attenuation of the Olson problem.

1. General Corporation Chartering

Empirically, U.S. corporations either incorporate in the state of their principal place of business or in Delaware.[162] The motivations for incorporating a firm in its home

transparency requirements of the Neuer Markt, such as quarterly reports, periodic meetings with analysts and financial results in accordance with IAS or U.S. GAAP. Small and high-growth firms are welcome to join this segment, but they are included in special industry indices.

[159] *See* Viertes Finanzmarktförderungsgesetz (Fourth financial markets advancement law) (2002).

[160] Deutsche Börse, *supra* note 158.

[161] We will not revisit here the large and influential body of literature discussing the existence of state competition for corporate charters. Suffice it to say that the characterization of state competition as a dual market strategy does not require vigorous charter competition by states other than Delaware nor the optimality of Delaware corporate law. It requires only that Delaware (or another state) be, overall, more protective of minority shareholders than other alternatives, which is a relatively uncontroversial proposition. For an overview of the origins of the debate on regulatory competition, *see, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 705 (1974); Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 289-92 (1977).

[162] Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1572 (2002) (describing a bimodal competition system in which nearly 95% of firms which incorporate outside of their home state choose Delaware).

state are very much of the Olson type.[163] Local businesspersons have strong influence on local politicians and courts, and hence on the structure of state corporate law -- including protection from takeovers, and particularly takeovers from out of state. State legislatures have not only enacted anti-takeover statutes to protect local firms from hostile threats in general, but have also passed legislation aimed at shielding specific target companies from an imminent or potential bid.[164] There are abundant examples of state-level legal reforms that have been hindered by local interest groups.[165] While there is good reason to believe that Delaware corporate law is more managerialist than efficiency calls for,[166] it is distinctly less protective of the interests of controlling shareholders, managers, and employees than is the corporate law of most other states. Delaware was, for example, conspicuously a latecomer with respect to antitakeover legislation, and its constraints on hostile bids are generally milder than elsewhere.[167]

Incorporating in one's home state also increases the chances that corporate litigation will take place in the courts of that state, where judges are more likely to be particularly sensitive to the interests of local businesspersons. And one suspects that, going in the other direction, incorporating locally is a signal that one considers one's interests focused in the home state, and hence increases one's local political influence. While much of the literature on state competition for corporate charters focuses on corporate law as a "product" and on the states' incentives (or lack thereof) to supply quality and innovation,[168] the political economy dimension is equally important. Delaware has special characteristics (such as its size, sunk investment in judicial services, and economic dependence on franchise taxes) that render its promise of an adequate corporate law regime credible and relatively immune from political interference due to constituency considerations.[169] Complementing, and perhaps making possible these structural barriers to local political influence, the small state of Delaware also lacks concentrations of labor organizations, shareholders, and other stakeholders with a direct interest in -- and the political clout to influence -- corporate law.

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[163] *See, e.g.*, Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 735 (2002) (noting that politics drives the laws of states other than Delaware, which are more likely to favor management than if they were motivated by competition).

[164] *See, e.g.*, Henry Butler, *Corporate-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365; Roberta Romano, *The Future of Hostile Takeovers*: Legislation and Public Opinion, 57 U. CIN. L. REV. 457, 461 (1988); Kahan & Kamar, *supra* note 163; Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987) (noting that the adoption of Connecticut's takeover statute was driven by one major company incorporated in the state); Robert Daines, *Do Staggered Boards Affect Firm Value? Massachusetts and the Market for Corporate Control* (working paper, 2001) (Massachussetts imposed a staggered board on all Massachusetts corporations in response to a request by one firm's management for protection from a single acquirer).

[165] *See* Kahan & Kamar, *supra* note 163. For example, New York labor unions have been able to block the elimination of section 630 of the Business Corporation Law, which holds the ten largest shareholders of a corporation personally liable for unpaid employee wages. Similarly, public interest lawyers and labor unions prevented the creation of a chancery court in Pennsylvania. *Id.*

[166] *See, e.g.*, Gilson, *supra* note 84, Bebchuk, *supra* note 84, Black & Kraakman, *supra* note 84.

[167] Kahan & Kamar, *supra* note 163.

[168] *See*, e.g., Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225 (1985); Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. REG. 209 (2006).

[169] Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. REG. 209 (2006).

Thus, giving local entrepreneurs the choice of incorporating either in their home state or in Delaware permits established firms to use their local political influence to maintain a protectionist legal regime of corporate law, while at the same time giving access to relatively efficient capital markets for those companies that need to raise substantial amounts of capital on favorable terms that reflect adequate shareholder protection.

Viewed from this perspective, the conventional characterization of the U.S. system of state-level chartering as "regulatory competition" is misleading and may in fact explain the absence of actual competition. In an important sense, Delaware corporate law is complementary to, rather than in competition with, the corporate law of other states. Without Delaware serving as an escape valve for those corporations that want and need a relatively efficient capital markets regime, there would surely be much greater pressure to reform the corporate laws of other states to orient them more strongly toward protective of shareholder interests, or alternatively to displace parochial state corporation law entirely by nationalizing corporate chartering.[170] Thus, rather than serving as a competitive constraint on protectionism in the corporate law of other states, Delaware corporate law arguably permits other states to offer law that is *more* protectionist than they otherwise could. And conversely, without state-level corporation statutes offering a degree of protectionism for stakeholders in local firms, a corporation law as market-oriented as Delaware's might be politically unsustainable. If, for example, the current system of state-level regulatory dualism were replaced with a uniform national system of federal corporate chartering, protectionist political pressures might well produce a body of federal corporate law that is less shareholder-oriented than is the law of Delaware.

The U.S. system of regulatory dualism in corporate chartering might seem, in contrast to Brazil's New Market, not an example of a strategy adopted to cope with the Olson problem, but rather simply a fortuitous natural concomitant of a well-developed system of federated lawmaking. And clearly the U.S. system was not self-consciously designed and adopted by a discrete group of actors, as was the Brazilian New Market, to circumvent long-standing political obstacles to reform. But the U.S. system of corporation chartering, with its liberal choice of law rule, was certainly not dictated by U.S.-style federalism. The legislators and courts that created the U.S. system of corporate chartering, and the interest groups behind them, could have chosen sharply different alternatives. Most obviously, corporations could have been required to incorporate in the state where their principal place of business was located, as under the "real seat doctrine" that prevailed in Europe until the last ten years.[171] Alternatively, a system of federal chartering could have been adopted that displaced local regimes. The system of bank chartering that developed in the U.S. in fact incorporated both of those approaches simultaneously, yielding until quite recently an extreme version of the Olson problem in U.S. credit markets that was strongly at variance with the relative efficiency of the country's markets for equity capital.

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[170] *See, e.g.*, Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) (arguing that the main legal competitor of Delaware is the federal government, not other states).
[171] *See* Part III(C).

2. Bank Chartering

Regulatory dualism in the chartering of industrial corporations has been a central feature of U.S. law since New Jersey's successful adoption, in 1875, of a liberal incorporation statute that was clearly designed to attract firms doing business in other states.[172]

The banking industry, however, was a conspicuous exception to this liberal approach to choice of chartering regime. Throughout the 19th and most of the 20th century, nearly all states excluded from doing business within their territory any bank chartered in another state. Indeed, most states went further and also either prohibited or severely restricted *intra*state branching by banks.[173] The states finally began to abandon these restrictions on interstate and intrastate banking in the late 1970s. Only in 1994, by which time most states had eliminated these restrictions, did Congress finally empower banks in general to engage in nation-wide business, free of state restrictions.[174]

The reason for the limitations on interstate and intrastate branching was local interest group pressure, which dominated the political economy of American banking from the Jacksonian era onward. Established local bankers did not want competition from out-of-state banks or from other, larger in-state banks. In this they presumably had the sympathy of established local merchants who already had well-developed relationships with local banks, and hence privileged access to the limited supply of credit that could be provided with the funds obtained from local depositors. New branch offices of banks from other regions would have meant increased access to capital for the merchants' aspiring competitors.[175] The losers from the branch banking restrictions, meanwhile, were the firms that could not be established or grow because of the lack of credit, as well as the potential consumers and suppliers of those firms, and bank depositors, who suffered from the absence of competition for their deposits from distant banks and borrowers.[176] But the latter groups were poorly organized in political terms. In short, for most of its history the U.S. banking industry suffered severely from the Olson problem.

There was an early effort to break this Olsonian stranglehold that nearly succeeded. As Olson would predict, it happened in a revolutionary moment, 1863, when the nation was deep in civil war, the Southern states were out of the legislature, and the national government was firmly in the hands of the Republicans. In that year and the two years following, Congress provided for the chartering of national banks that would have

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[172] New Jersey was highly successful in this venture, and remained the dominant jurisdiction for out-of-state chartering until early in the 20th century, when it stumbled under Governor Woodrow Wilson and was replaced by Delaware, which has remained dominant in that role ever since. *See* Henry Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEG. STUD. 129 (1985).
[173] The history of these restrictions is recounted briefly in Geoffrey Miller, *Interstate Banking and the Court*, 1985 SUP. CT. REV. 179, 181-83.
[174] Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (codified as amended at 12 U.S.C.§ 36 (2006)).
[175] Raghuram G. Rajan & Luigi Zingales, *supra* note 3, argue more generally that incumbents oppose financial market development – here the allowance of interstate banking – because it increases competition.
[176] Prasad Krishnamurthy, *Financial Market Integration and Firm Growth: Evidence from U.S. Bank Deregulation* (working paper, 2009), provides empirical evidence of the effects of U.S. branch banking restrictions on business growth, and surveys as well the previous literature on the subject.

exclusive authority to issue a uniform national currency. The legislation simultaneously imposed a confiscatory 10% tax on the issue of banknotes by state-chartered banks. Because banknotes were a principal source of income for the state banks, these enactments were expected to effectively eliminate state-chartered banks and replace them with a nationwide system of federally chartered banks. In fact the number of state banks decreased by more than 80% in the immediately succeeding years. But the state banks subsequently found new sources of business -- principally through the development of checking accounts, and began to rebound. And, once the political equilibrium returned to the status quo ante bellum, the state banks were allowed to flourish under their protectionist state-level chartering regimes, while the newly created national banks were subjected to restrictions that prevented them from offering serious competition to state banks. In particular, subsequent federal legislation provided that federally-chartered banks could do interstate business, or maintain intrastate branches, only if state-chartered banks had the same authority under local state law.[177]

These developments gave rise to what is commonly termed a "dual banking system," under which a bank had the alternative of seeking either a federal or a state charter. The result was not, however, a meaningful degree of regulatory dualism in the sense that we use the term here. The federally-chartered national banks did not ultimately offer a solution to the Olson problem in banking.[178]

The consequence was extraordinary fragmentation in American banking until the last decades of the 20th century. This pattern contrasted strongly with the highly concentrated nationwide banking systems in other developed nations. The best empirical estimates suggest that this fragmentation of the American banking system produced substantial inefficiencies in the allocation of credit to businesses and in the rates of return available to depositors.[179] It is generally thought responsible for the small role of bank-centered financing for large industrial firms in the United States as opposed to other leading industrial nations.[180]

The United States never solved the Olson problem in consumer banking through the mechanisms of political economy. The system collapsed in recent decades principally because of changes in technology that permitted institutions other than banks, and banks located in other states, to provide effective competition to state-chartered local banks despite the efforts of the states to shield them.[181] Until that happened, individual states were generally incapable of breaking the political stranglehold of local bankers and permitting out-of-state banks to do business in the state, or even permitting intra-state banks to compete with each other beyond the single community in which they were located. Nor were political forces at the national level capable of overcoming the power of local bankers and passing legislation either (1) adopting the approach taken to

[177] *See* Miller, *supra* note 173; JONATHAN MACEY & GEOFFREY MILLER, BANKING LAW AND REGULATION: CASES AND MATERIALS 8-9 (2d ed., 1997).
[178] On the lack of real choice of regulation offered by this "dual" system, see Henry Butler & Jonathan Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677 (1988). Butler and Macey emphasize that maintenance of this inefficient regulatory regime benefited yet another entrenched interest group, namely the regulators.
[179] *See* Krishnamurthy, *supra* note 176.
[180] *See, e.g.*, MARK ROE, STRONG MANAGERS, WEAK OWNERS 54-59 (1996).
[181] *See* MACEY & MILLER, *supra* note 177, at 27-29.

chartering of industrial corporations by denying states the authority to exclude firms incorporated in other states, or (2) giving federally-chartered banks authority to operate nationwide, free of restrictive state regulation. Either of these approaches, and particularly the first, could well have led to a regime of regulatory dualism like that which developed for chartering industrial corporations, with state-chartered firms gaining some degree of insulation against market pressures while sacrificing, perhaps, some degree of access to credit or other market opportunities available to banks chartered under the alternative nationally-oriented regime.

Why was the Olson problem more resistant to solution in banking than among industrial firms? One answer that does not seem plausible is that banking is an industry that holds unusually strong potential hazards for its customers that can -- or at least in the past could -- only be controlled adequately through local chartering.[182] A more likely explanation lies in the structure of the banking industry in the first half of the 19th century, with its large numbers of local banks that had relatively homogeneous interests in shielding themselves from competition. Those banks naturally formed a powerful interest group -- and one that could probably count on support, as suggested above, from established firms to which they provided credit. Moreover, the restrictive chartering system for these banks, once in place, assured that the industry would retain its original structure, and hence its political strength. Manufacturing firms, being more heterogeneous, perhaps could not form themselves into such an effectively coherent political force, and hence could do no better than maintain local chartering in the context of regulatory dualism.

Perhaps, moreover, the differing degrees of protectionism afforded banking and the equity markets were complementary. If, as in most of the rest of the developed world, an efficient national banking system had developed early on a scale that could provide substantial industrial financing, there might well have been less pressure in the United States for an efficient system of equity markets, and the U.S., like Europe, would have adhered much longer to a system of local state control over the chartering of industrial firms and the less minority-shareholder-friendly approach to corporate law that such a system permits. Conversely, if the U.S. had not developed a relatively efficient system of law to govern its equity markets, there might well have been much stronger pressure to reform its system of bank chartering to permit the emergence of nationwide banks of sufficient size to meet the capital needs of large industrial firms. In a sense, then, the contrasting systems of chartering for banks and industrial firms in the United States also constitute regulatory dualism.[183]

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[182] *See* Geoffrey Miller, *supra* note 173, at 208-25 (1986). That protection of banks rather than their customers was not just the consequence but the motivation of the geographical restrictions on banking is nowhere so transparent as in the series of regional compacts through which the states gradually retreated from these restrictions. *Id*. at 187-95. Indeed, the path of deregulation in the last quarter of the 20th century, in which states first admitted banks from other states that offered only minimal competition, while continuing to exclude banks from the major banking states such as New York, Illinois, and California.

[183] The role of the New York Stock Exchange (NYSE) in the late nineteenth and early twentieth centuries also contained some elements of regulatory dualism. Like the Brazilian New Market, the NYSE, a private organization, imposed stricter standards on corporations than did state corporation law. Thus, in 1916 the NYSE began requiring newly listed corporations to provide quarterly statements of earnings and balance sheets, and in 1926 it famously banned the issuance of non-voting stock by listed companies.

C. The EU Choice of Corporate Law Regime

Following the ECJ's decision in *Centros*, the European Union's approach to capital market regulation, like the U.S. system that it increasingly resembles, effectively embodies a dual regulatory strategy.[184] To see this, assume that elements of German corporate governance regulation, most notably co-determination, are ill-suited to the formation and growth of new economy companies. But reforming co-determination to eliminate the barriers to the growth of new economy companies directly confronts the Olson problem: economic growth requires regulatory reform that is blocked by existing elites whom the reform would disadvantage.[185] In the context of co-determination, a plausible compromise might be to exclude new economy companies from the application of the regulation, while leaving the established large industrial companies subject to the existing requirement of employee participation in corporate governance. But here we again confront the Olson problem. Politically powerful German labor unions oppose any

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Contemporary commentators described the NYSE Listing Committee as requiring "a most elaborate and painstaking disclosure of the material facts in connection with the corporation, which is subjected to a searching analysis by the committee prior to the admittance of stock trading." ADOLPH BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 275 (1932). Indeed, the first SEC disclosure forms were themselves based on the NYSE listing standards, Paul J. Mahoney, *The Exchange as a Regulator*, 83 VA. L. REV. 1453, 1466 (1997), and various studies have documented the efficacy of the Exchange's early disclosure requirements. *See, e.g.*, George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973) (finding significant compliance with the NYSE's disclosure requirements); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964) (arguing that the NYSE listing standards fared well compared to the effects of subsequent securities regulation); Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295, 311 (1989) (noting that, prior to the enactment of the securities acts, investor forecasts were significantly more accurate with respect to NYSE-listed firms).

If the NYSE had enjoyed a monopoly on access to the public market for trading stock, its role might not qualify as an instance of dualism. But in fact the NYSE faced significant competition from the Consolidated Stock Exchange, the Curb Stock Exchange (later AMEX), and other regional exchanges, all of which had much more relaxed standards, John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L. J. 1, 65 (2001), and some large family-controlled corporations – including Standard Oil of New Jersey , U.S. Tobacco, and United States Sugar -- opted for Curb trading for the purpose of avoiding the NYSE disclosure requirements. ROBERT SOBEL, AMEX: A HISTORY OF THE AMERICAN STOCK EXCHANGE, 1921-1971 14 (1972).

The NYSE listing rules continue to impose corporate governance standards that go beyond those mandated by federal and state law, such as additional shareholder approval and director independence requirements. Today, however, the significant influence of the SEC in the enactment of such listing standards, and the relatively marginal contribution to investor protection that the NYSE standards now make when compared with mandatory law, make it difficult to view the NYSE listing rules as an instance of regulatory dualism.

[184] *Centros Ltd. v. Erhervsog Selskabsstyrelsen*, Case C-212/97, 1999 E.C.R. 1459. For a description of the *Centros* decision in terms of the Olson problem, *see* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001).

[185] Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 163 (Margaret Blair & Mark Roe eds., 1999), traces the political history of worker involvement in corporate governance.

reform of co-determination because of the concern that any change threatens the entire regime.[186]

In this circumstance, a regime of regulatory dualism that could not be adopted by the Bundestag was externally imposed (whether or not intentionally) by the European Court of Justice in its *Centros* decision. *Centros* allows a new corporation to incorporate in any EU state, and establish its business in any other EU state, even though the state of incorporation's corporate governance system may impose fewer restrictions than the country in which the business is actually carried out and which, prior to *Centros*, would have been applicable because of the real seat doctrine.[187] For example, after *Centros* a biotech startup relying on German scientists for talent could incorporate in the U.K., thereby avoiding the German co-determination regime, while still locating its business in Germany. At the same time, existing large German companies would remain subject to co-determination because of the remaining large barriers to shifting its incorporation to another jurisdiction, whether through merger[188] or via direct transfer of state of incorporation.[189] Thus, *Centros* in practice imposed regulatory dualism with respect to codetermination: new companies were allowed to opt out by foreign incorporation, while the sources and focus of labor's political power -- existing large companies -- remained subject to local regulation.[190]

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[186] The analysis is not limited only to labor protections arrangements. The structure of corporate governance in a particular country may reflect a "deal" between labor and rich families, which supports the maintenance of family control through multiple voting stock and pyramid holdings in return for labor participation in governance. *See* Peter Högfeldt, *The History and Politics of Corporate Ownership in Sweden*, *in* A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 517, 522 (Randall Morck ed., 2005) (arguing that an alliance between wealthy families and Social Democrats led to entrenched family control of corporations in Sweden).

[187] *See Centros, supra* note 184; *Überseering BV v. Nordic Construction Company Baumanagement GmbH* (NCC), Case C-208/00, 2002 E.C.R. 9919; *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.*, Case C-167/01 2003 E.C.R. 10155.

[188] The typical method for an established company to switch its state of incorporation is to merge the existing company into a subsidiary newly formed in the destination state. While the E.U. Cross-Border Merger Directive, 2005/56/EC of 26 October 2005 on cross-border mergers of companies with share capital, *OJ* 2005 L 310/1, generally facilitates cross-border mergers, it is not of much help if the goal is to avoid employee governance participation. If the existing state of incorporation requires worker participation and the destination state does not, as contemplated here, the directive imposes a set of standard employee governance rules. *See* Mathias E. Siems, *The European Directive on Cross-Border Mergers: An International Model*, *in* CORPORATE MERGERS 156 (P.L. Jayanthi Reddy ed., 2008).

[189] A second method by which to shift a corporation's state of incorporation is to simply transfer state of incorporation, accomplished by dissolving the existing corporation and reincorporating it the target jurisdiction. This process is said to be unworkable. "Given the high costs involved, the time involved and the related administrative burden, with sometimes more than 35 procedural steps to overcome, this hardly ever occurs and European companies are, in practice, deprived of the possibility of moving their place of registration within the EU." Impact Assessment on the Directive on the Cross-border Transfer of Registered Office, SEC (2007) 1707 (Dec. 12, 2007), While the European Commission has determined not to proceed with a transfer of registered office directive, the proposals all assumed that employee participation would be protected in much the same fashion as in the cross-border merger directive. *See id.*, Resolution of European Parliament, 2008/2196 (INI) (March 10, 2009) (recommending a transfer of registered office directive).

[190] A slightly more nuanced formulation of this point recognizes that the *Centros* dual regulatory regime provides companies a choice only with respect to worker participation imposed by the corporate

While different in structure than the Brazilian New Market strategy, *Centros* has a similar effect on the Olson problem: a mechanism that lets the new economy develop while leaving the existing power structure – in the case of co-determination, labor – unaffected.

Despite the effective abandonment of the real seat doctrine, established European firms are under little pressure to change their state of incorporation. The merger technique typically used for change of jurisdiction can generally be blocked by current controlling shareholders, by managers or, in Germany, by employees. This is partly because the breakthrough rules that might weaken such power have not been adopted by states that wish to continue to regulate domestic firms with domestic corporate law – which is to say, by states whose firms wish, Olson-like, to continue to be governed by domestic corporate law. Consequently, it is primarily newly formed firms that exploit the new freedom to incorporate in a state other than that of their real seat. Thus new firms, which are those most likely to need access to new equity capital, are given access to efficient capital markets (by means of incorporating in a jurisdiction, such as the UK, that provides the necessary legal regime). Yet at the same time established firms and their owners (and employees) continue to be governed by their traditional local legal regime, which they can also continue to shape as they wish for the foreseeable future -- at least until newly established firms become so large and numerous as to dominate the local political scene.[191]

IV. Related Regulatory Strategies

Regulatory dualism shares some characteristics with other techniques used to manage the transition from one regulatory regime to another, but has important differences that help identify its proper domain. In this part, we focus on several of these alternative techniques. Again, we focus particularly on applications in corporate law, though all these techniques are applied much more generally.

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governance system. Worker participation imposed by other regulatory regimes, like workers councils imposed by labor law, cannot be avoided by foreign incorporation.

[191] To some extent, the text overstates the exit barriers confronting established German corporations. The maintenance of employee participation in governance required by the Cross-Border Merger Directive is diluted if the surviving firm then engages in another merger with a company chartered in the same member state. In that event, the Directive requires that employee participation be maintained only for an additional three years. Directive 2005/56/EC, Art. 16, sec. 7. Since the language of the directive refers only to "subsequent domestic *mergers*" (emphasis added), an argument is available that changes in the legal form of the surviving company other than by merger will "launder" the employee participation requirement without the three-year lag. Similarly, a German company might accomplish the same result by a division, thereby shifting the state of incorporation of a portion of its business by a non-merger technique that falls under *Centros'* freedom of establishment regime but outside the application of the Cross-Border Merger Directive and its protection of employee participation in governance. *See* Lone L. Hanson, *Moving and Decision Across National Borders – When Case Law Breaks Through Barriers and Overtakes Directives*, 1 EUR. BUS. L. REV. 181 (2007). Finally, simple reincorporation may be available after the European Court of Justice's decision in Cartesio, C-210/06, which constrains a member state from restricting reincorporation by treating it as a liquidation under local law.

Notwithstanding the variety of techniques by which an established German company may with patience and subtlety escape an employee participation regime, the transactional and legal barriers stand in sharp contrast to the unfettered discretion of an early stage company simply to choose a more favorable jurisdiction in which to incorporate. The differential still operates as a dual regulatory regime.

A. Grandfathering

Grandfathering, as the term is typically used, involves the promulgation of reformist rules that are mandatory for firms (or other persons) that become subject to the regulatory regime only after the reformist rules are enacted, while firms that had been subject to the pre-existing regulatory regime can continue to be governed by that older regime. Regulatory dualism is distinguished from grandfathering in that the reformist regime is not mandatory for newly regulated firms; both the established and the reformist regimes remain available to both old and new firms. In contrast, grandfathering imposes a mandatory transition process from old to new rules.

Efficiency, including the value of legal predictability and stability, may justify grandfathering regardless of political constraints -- particularly where firms have made long-term specific investments in reliance on prior law.[192] Nonetheless, grandfathering is also often employed to circumvent the Olson problem. In corporate law, grandfathering is particularly common with respect to statutory changes affecting voting rights. Brazil resorted to grandfathering in its 2001 legal reforms by exempting existing companies when it reduced the statutory ceiling for the issuance of non-voting preferred shares from two thirds to one half of a firm's total capital.[193] The U.S. listing rules that substituted for SEC rule 19c-4, barring potentially abusive dual class recapitalizations, also included a broad grandfather exemption for companies with existing dual capital structures.[194] Similarly, New York's 1997 amendment to its Business Corporation Law made a number of changes in voting rules, but specified that that new rules applied immediately only to companies incorporated in New York after the effective date of the statute; old companies remained largely unaffected unless they affirmatively opted into the new regime.[195]

Even though grandfathering may be useful as an ancillary technique to circumvent the Olson problem in modest legal reforms, it is difficult to find situations where it has been used to provide an entirely new regulatory scheme. In this important respect it differs markedly from regulatory dualism, which functions to provide ongoing parallel systems, as in the corporate governance regimes we examined in previous Parts.

There are several reasons for this disparity. First is the updating problem. If only a declining number of established firms are affected by the older regulatory regime, both the incentive and the opportunity may be lacking to make adjustments in that regime to maintain its efficiency even in serving the needs of the firms it covers. Indeed, any changes in the established regime may be questionable as inconsistent with the commitment to stasis involved in grandfathering. A second problem with grandfathering involves its apparent legitimacy. By its nature -- indeed, by its very name -- a grandfathered regime has an air of being antiquated, and increasingly so over time. The use of grandfathering, as opposed to regulatory dualism, reflects a fundamentally

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[192] Steven Shavell, *On Optimal Legal Change, Past Behavior, and Grandfathering*, 37 J. LEGAL STUD. 37 (2008) (arguing that grandfathering is efficient when switching costs are high).

[193] Despite their grandfathering protection for old public firms, the new statutory rules were rather timid, and were later dwarfed by the New Market requirements banning non-voting shares altogether. *See* Parts I(a) and (b) *supra*.

[194] *See, e.g.*, NYSE Listed Company Manual, § 313.00.

[195] Renee L. Crean, *Recent Development in New York Law*, 72 ST. JOHN'S L. REV. 695, 700 (1998).

different assessment of the value of the two regulatory regimes. Grandfathering eliminates the prior regulatory structure in favor of one whose mandatory character going forward makes a clear statement of relative efficiency; as a limited concession, firms that have specific investments in the old regime may continue it. In contrast, regulatory dualism is at least facially agnostic with respect to the relative values of the business arrangements that each regime sanctions. As a matter of politics, this is a point of particular significance in dealing with the Olson problem.

Third, concerns about disparate treatment before the law can generate hostility towards grandfathering.[196] Regulatory dualism has the advantage that both the old and the new regime remain available to all. And finally, grandfathering, by providing new rules that are mandatory only for new firms, may be particularly subject to opportunistic manipulation to the further benefit of the established firms. In particular, established firms that are protected by the grandfathered rules may use their influence to distort the rules applicable to new firms, imposing on the new firms onerous and inefficient statutory requirements that, though nominally protective of the public (such as noncontrolling shareholders), in fact erect barriers to entry that shield the established firms from competition.

B. Menus

Statutory menus,[197] which offer both old and new firms a choice between two or more alternative rules governing a particular issue within a comprehensive scheme of regulation, can embody a form of regulatory dualism that is directed at the Olson problem if, as is often the case, the menu items include both established and reformist rules.

Japan conspicuously employed this strategy when it reengineered its corporate governance system in 2002. The amendments to the Commercial Code gave firms the opportunity to adopt a new, Anglo-American corporate governance regime on an opt-in basis.[198] In particular, firms could choose between the traditional Japanese system based on a board of auditors (*kansayaku secchi kaisha)* and a U.S.-style board-centered corporate governance regime (*iinkai secchi*). The legislature's decision to offer a choice, rather than a mandatory shift to a board-centered system as originally proposed, was a response to opposition from traditionalists both within and outside the government who objected to the imposition of a new governance system. Seven years after the reform, 112 publicly traded firms had taken advantage of the option to embrace the new system.[199]

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[196] CARVALHOSA, *supra* note 38 (arguing that the 2001 reform's different treatment of old and new Brazilian firms with respect to preferred shares is inequitable and unconstitutional).

[197] On menus in general, particularly in the context of corporate law, see Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3 (2006); Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination*, http://ssrn.com/abstract=924578 (2007).

[198] *See* Ronald J. Gilson & Curtis J. Milhaupt, *Choice as Regulatory Reform*: *The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343 (2005).

[199] Robert N. Eberhart, *Comparative Governance Systems and Firm Value: Empirical Evidence from Japan's Natural Experiment*, Working Paper, Walter H. Shorenstein Asia-Pacific Research Center, Stanford University (Aug. 2009). Companies that adopted the *iinkai secchi* structure initially improved their performance compared to industry competitors that retained the traditional governance structure. Id. This advantage diminished after two years, illustrating the existence of an informal item on the menu.

Another familiar example of the menu approach in the U.S. is section 102(b)(7) of the Delaware General Corporation Law, which effectively gave corporations a choice between two alternative liability regimes for violations of corporate directors' duty of care: a very low "reform" standard that virtually eliminates director personal liability for duty of care violations, and a potentially higher existing standard – the Delaware Supreme Court's holding in *Smith v. Van Gorkom*,[200] in response to which Section 102(b)(7) was enacted.[201] And Brazil's 2001 legal reform also deployed the menu approach, even if only modestly. For example, unlike the 1997 reform, which compensated for the lack of voting rights for preferred shares by imposing a mandatory 10% higher dividend for all preferred shares, the 2001 statutory amendments provided a broader menu of alternative preferences for non-voting preferred shares, ranging from favorable dividend treatment compared to common shares to tag-along rights at a price equal to at least 80% of that paid for the controlling block.[202] Despite initial scholarly skepticism about the utility of such a menu, many companies later adopted preferences viewed as more protective of minority shareholders, such as tag-along rights. In addition, by rendering shareholder agreements increasingly self-enforceable, the 2001 statutory amendments also enabled firms to embrace shared control arrangements in the New Market.[203]

The statutory menu approach to regulatory dualism has the weakness, however, that it seeks to embed the reformist regime in the same statute that provides the established regime. The result is that the reformist regime, in all its details, must be accepted by the political forces that have long shielded the established regime. In the most successful approaches to regulatory dualism, in contrast, the reformist regime has been created and maintained by an institution -- such as a stock exchange or another federated state -- that is to some degree independent of the political forces supporting the established regime. We consider this question of institutional choice more carefully below.[204]

C. Default Rules

A more liberal approach than menus to the creation of alternative regulatory regimes is to delegate to the regulated firms themselves the task of designing the reformist (or, in some cases, the established) regime. This is done commonly in corporate law by enacting portions of the established regime in the form of default rules

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Because the traditional system was sufficiently malleable to allow the adoption of some elements of the *iinkai secchi* structure without a statutory change, informal selection of an intermediate combination of attributes may have reduced the performance differences between the two regulatory regimes. Id. Thus, depending on the context, informal alternatives may be nested within a menu structure's formal choices.

[200] 488 A.2d 858 (Del. Supr., 1985).

[201] Del Code Ann. tit. 8, § 102(b)(7). As is widely understood, Delaware corporations had no difficulty making the choice – virtually every company adopted the contemplated charter amendment.

[202] Article 17 of the Corporations Law requires that non-voting preferred shares receive one of the following preferences: (i) mandatory dividends at a rate of 25% as percentage of net profit, subject to priority in dividend payment up to 3% of the share's net equity value, (ii) a dividend rate at least 10% higher than that paid to common shares, and (iii) tag-along rights in the event of control sale at a price equal to at least 80% of that paid for the controlling block.

[203] *See* notes 77 and 78 *supra* and accompanying text.

[204] *See* Part V *infra*.

from which firms are free to deviate by specific alternative provisions in their charters. This approach has the advantage of permitting reformist regimes that are tailored to the needs of each individual firm. It also does not require the creation of a separate regulatory body to administer the reformist regime.

But simple default rules suffer from three basic weaknesses as a dualist response to the Olson problem. The first is that privately-contracted alternatives to the established regime do not bring with them an enforcement mechanism apart from the general modes of contract enforcement. The second is that the alternatives to those defaults that individual firms choose may not be well coordinated, resulting in a proliferation of alternatives that undercuts network effects in signaling, interpretation, and (contractual) enforcement. And the third, and arguably most serious, weakness of the simple default rule approach is that it is not a form of *regulatory* dualism. That is, it does not provide for a regulatory institution outside the firm that provides the reformist rules, but instead leaves those rules to be created by contract among the firm's stakeholders. And the weakness of contractual rules lies in their amendability, or lack of it. If the special contractual constraints are subject to easy amendment without unanimous assent of the affected stakeholders, then there is room for opportunistic changes to the detriment of one group or another. On the other hand, if all affected stakeholders are given a veto over amendment of the customized rules, those rules risk becoming outdated and costly as the firm and its environment change over the many years of its expected lifetime. A third-party regulatory institution – whether legislature, court, or agency -- can provide, in effect, "delegated contracting," altering the rules of internal corporate governance for firms over time as, and only as, alterations are needed.[205] These concerns arguably go far in explaining the remarkable fact that publicly-traded corporations in the U.S. rarely deviate from default statutory law in their charters, despite their great freedom to do so.[206] Paradoxically, contract terms fare worse than legal rules in adapting to new conditions.

D. Grand Bargains

By definition, regulatory dualism is a second-best solution that allows policymakers to circumvent the blocking power of incumbents to sweeping, if efficient, legal reforms. But, at least in theory, regulatory dualism is not the only possible strategy to address the Olson problem. Simply buying off the existing controlling shareholders prior to legal reforms is another alternative. For example, in exchange for accepting sweeping mandatory reform of the rights of noncontrolling shareholders in all corporations, both old and new, controlling shareholders in established firms might be given a time-limited right to purchase all of their companies' publicly-traded shares at low prices reflecting the weak rights of shareholders under pre-existing law. Those purchases might be aided by government financing, which could be repaid when the shares were subsequently resold on the public markets, after the adoption of the legal reforms, at the higher prices those reforms would induce.

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[205] Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1 (2006).

[206] *Id. See* also, Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J. L. ECON. & ORG. 83 (2001).

This approach was, in fact, partially employed in Brazil, even if inadvertently. In permitting controlling shareholders to take their companies private in abusive transactions in the late 1990s, Brazil effectively reduced the number of actors having a vested interest in opposing subsequent legal reforms to increase minority rights.[207]

However, the grand bargain approach also has its limits. In the Brazilian case, it served to hurt investor confidence in local capital markets but did not sufficiently reduce the number and political clout of existing publicly-traded firms to enable comprehensive reform and render regulatory dualism redundant. But more ambitious and explicit attempts to bribe the existing elites to accept legal reforms – such as government bridge loans for exploitative share repurchases, as described above -- are unlikely to be politically feasible.

V. Who Provides the Reformist Regime?

As the preceding discussion of default rules suggests, an effective system of regulatory dualism requires that the reformist regime be provided by a regulatory authority with some independence from the regulated -- and especially the established -- firms. We turn now to the potential sources of that authority.

A. The Problem of a Unitary Lawmaker

In the menu approach to regulatory dualism, a single lawmaker – generally a legislature -- establishes and maintains each of the alternative regulatory regimes. As a solution to the Olson problem, this approach has the obvious limitation that establishment of a reformist regime must confront the same interest group pressures that support the established regime; in comparison, the stock exchanges in the cases of Brazil and Germany were motivated by their own profit both to open the exchange to a new class of listing companies and to accomplish this without alienating the existing traditional companies. Even if elite interests cannot entirely block reform through a new legislative menu, they may succeed in limiting the menu to meager choices. To be sure, a single legislature might find it easiest to accommodate both the establishment and reformist political forces by establishing dual regimes rather than, for example, seeking to develop a single compromise regime. The recent Japanese corporate governance reforms are an example. But, though they aroused intense political opposition,[208] those reforms are less than earthshaking, representing only a modest deviation from Japan's managerialist system of corporate governance, and they have been taken up by only very few companies. Similarly, while the menu approach to reform of preferred stock embodied in Brazil’s 2001 statutory reform has had some success, it is modest compared with what has been achieved by the New Market. And Delaware’s menu approach to directors’ duty of care has collapsed into near meaninglessness, as firms have almost uniformly adopted exculpatory provisions as permitted by 102(b)(7), while the courts have both retreated from what momentarily seemed a higher standard of care and expanded the content of the duty of loyalty (which is not subject to exculpation under 102(b)(7)) to

[207] *See* notes 37-40 *supra* and accompanying text.
[208] *See* Gilson & Milhaupt, *supra* note 198; Eberhart, *supra* note 199.

encompass some obligations previously covered by the duty of care,[209] hence arguably removing most of the difference between the old and the new regime.[210]

With perhaps the exception of the Japanese case, it is in fact difficult to find an example of a single jurisdiction that offers two markedly alternative systems of corporate law, one established and one reformist. In theory, it should be perfectly possible. Delaware, for example, might attract to itself even more of the corporate charter business in the United States if it were to offer, in addition to its current mildly reformist corporation statute, an alternative corporation statute that is much more protective of the interests of managers and controlling shareholders.[211] Alternatively, states with corporation statutes that currently cater to managers and controlling shareholders could adopt, in addition, an alternative statute that is as or more protective of noncontrolling shareholders as Delaware's corporation law. But -- aside from an arguably quixotic recent effort in North Dakota[212] -- we don't see this. Strong forms of regulatory dualism seem to require that the alternative regulatory regimes be promulgated and maintained by separate authorities that are at least to some degree subject to different political pressures. Each of the prominent examples of regulatory dualism we have examined in earlier sections of this article has this character. We proceed to examine several approaches of this type, exhibiting increasing degrees of political isolation for the reformist regime.

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[209] In *Stone v. Ritter*, 911 A.2d 362 (Del. Supr., 2006), the Delaware Supreme Court held that the duty of oversight established under *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), a classical duty of care case, could give rise to a violation of the duty of loyalty if the directors failed to discharge their fiduciary obligations in good faith). *See* Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769 (2007) (defending the use of the duty of good faith to enlarge the scope of director liability for breach of the duty of loyalty); Stephen M. Bainbridge, Star Lopez & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 597 (2008) (attributing the Delaware Supreme Court's decision in *Stone* as "another case in which section 102(b)(7) seems to be driving the analysis").

[210] For some perspective on the tortured evolution of the duty of care under Delaware law, *see* William T. Allen, Jack B. Jacobs & Leo E. Strine, *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449 (2002).

[211] In a limited fashion, Delaware has provided a menu that allows reducing fiduciary duty to the obligation of good faith and fair dealing, but this is limited to alternative forms of corporations, rather than traditional corporations. Some of these forms, however, like master limited partnerships, are suitable for public ownership. *See* JESSE CHOPER, JOHN C. COFFEE & RONALD J. GILSON, CASES AND MATERIALS ON CORPORATIONS C.7 (2008)(describing development of the obligation of good faith and fair dealing as an alternative to fiduciary duty). Daines and Klausner's showing that Delaware corporations going public typically have plain vanilla charters even though the statute allows for substantial variation, suggests that Delaware understands that there is little market for higher standards. Daines & Klausner, *supra* note 206.

[212] Under a 2007 reform to the North Dakota Publicly Traded Corporations Act promoted by corporate governances advocates, firms incorporated under North Dakota law after July 1, 2007 can insert a provision in their articles of incorporation that subjects them to a bundle of strong shareholder rights, including majority voting for directors, advisory shareholder votes on executive compensation, the ability to propose board nominees on the company's proxy statement, and reimbursement of proxy expenses incurred by insurgent shareholders. *The North Dakota Publicly Traded Corporations Act*, 2007 N.D. Session Laws, ch. 102 , 497-517 (Apr. 10, 2007). Since firms already incorporated in North Dakota before 2007 are presumably free to reincorporate and thereby take advantage of the new shareholder-oriented provisions, both the established and the reformist regimes are available to both old and new firms, making this a straightforward example of regulatory dualism.

B. Dualism via Private Regulatory Organizations

One alternative is for the reformist regime to be provided by a third-party private or semi-private organization that is relatively independent of the governmental institutions that provide the established regime. Both Brazil's New Market and Germany's Neuer Markt are examples of this approach, in which a stock exchange acts as the regulatory body. Following a pattern typical in the industry, both of these exchanges were, at the time the new market reforms were adopted, mutual organizations controlled by the brokers and dealers who had trading privileges on the exchanges, and then were converted to investor-owned firms. Under both forms of ownership, the returns to those who control the exchanges is maximized by maximizing the volume of securities that are traded and the prices at which those securities trade. This provides an incentive, in turn, for the exchanges to establish rules of corporate governance that are relatively favorable toward noncontrolling shareholders. And since there are economies of scale and scope in stock exchanges, the exchanges typically have substantial market power over companies whose stocks the exchanges list for trading. There is a limit to that market power, however, so that if the exchanges are too aggressive in imposing strict rules of corporate governance upon listed firms, at some point they will start to lose listings as firms seek other venues where their shares can trade. Additionally, the particular regulatory structure in which a stock exchange operates will constrain their freedom of action. For example, both in the U.S. and in Brazil, the requirement that exchanges secure SEC (or, in Brazil's case, CVM) approval of changes in their rules provides a tangency between private and public action that creates an opportunity for the Olson problem to inhibit reform by an exchange more directly.

1. Enforcement

Private organizations such as stock exchanges are handicapped by lacking the enforcement tools -- and in particular the punishments -- available to governmental bodies. Nonetheless, private organizations can deploy some enforcement tools that go beyond mere contract enforcement. The new markets in Brazil and Frankfurt both had the power -- granted contractually in return for listing privileges -- to impose fines upon firms that deviated from their rules. And ultimately the exchanges could threaten to delist a deviant firm. As we have seen, however, the Frankfurt Neuer Markt had very lenient fines and, even so, rarely imposed them -- perhaps because it was afraid of discouraging firms from listing on the exchange.

Weak enforcement contributed to the widespread scandals that undermined the credibility of the Frankfurt Neuer Markt. Brazil's New Market has so far escaped such problems. Whether its enforcement powers will prove, in the long run, adequate to support its rigorous listing standards – and the extent to which the CVM continue to play an active role in investor protection – remain to be seen.

2. Network Efficiencies

Unlike individual agreements, but similarly to legal rules, the delegated contracting provided by a private regulatory organization serves as a focal point for the coordination of investor expectations, so that shareholders of any individual member firm acquire an interest in the reputation and reliability of the entire segment. An instance of investor expropriation at any given listed firm will affect an interest group well beyond that firm's shareholders. Consequently, as the number of listed firms and shareholders relying on these new standards increases, so do its apparent legitimacy and the probability of enforcement of its provisions.

But network effects can also undermine a private regulatory organization. A main reason for the failure of the Neuer Markt in Germany was also a main driving force of its initial success – that is, its focus on high-tech companies. As the dot.com bubble burst in the late 1990s, a plunge in stock prices, accompanied by a series of scandals involving member firms, eroded the credibility of the entire segment. In such circumstances, a more diversified private regulatory organization such as Brazil's New Market (which is open to any firm willing to comply with its requirements) is more likely to remain viable.

3. Revision of Regulations

Even if enforcement deficiencies can be overcome, the main challenge to establishing a reformist regulatory regime through a private regulatory organization is, as we have suggested above, adaptation over time. The ability to adapt to new circumstances is key to protecting noncontrolling shareholders from an ever-growing spectrum of expropriation opportunities cleverly devised by sophisticated advisors; to have a comparative advantage, the private organization must avoid the petrification inherent in public regulation. The inability of Frankfurt's Neuer Markt to remodel its requirements in a moment of crisis -- a consequence, in important part, of judicial interpretation of those requirements as contractual in character -- provides a cautionary tale for similar institutions, such as Brazil's New Market.

The ability of the São Paulo Stock Exchange to revise the New Market's listing rules over time is constrained by the segment's institutional design. Unlike its predecessor Neuer Markt, the New Market explicitly requires the tacit approval of at least 2/3 of listed firms to any changes in the listing standards. Subject to the approval of the Brazilian SEC, revisions of the listing rules are binding upon all New Market firms unless 1/3 of them expressly oppose the changes during a restricted hearing required under the New Market regulations.[213] Although this qualified majority approval condition, together with other features of the New Market, should prevent the courts from treating the New Market rules as contracts unalterable without the unanimous consent of the regulated firms, the result may nonetheless be substantial rigidity in the system. The incentives of firms to commit to stringent corporate governance requirements, which are most powerful at the time of their IPO and entry to the New Market, can easily fade over time, especially when the firm does not plan a new capital issuance in the near future. Listed firms will have an incentive to act opportunistically when voting on stricter regulations, with the consequence that the frequency and quality of amendments may be suboptimal from a shareholder value perspective.

The New Market reform system is currently being tested as the São Paulo Stock Exchange is, for the second time, proposing major changes to the listing standards. So far, the New Market has an overall positive track record in amending its regulations. The listed firms successfully approved changes to the premium listing standards in late 2005.

[213] Novo Mercado Listing Rules, Section 14.2.

A few of the changes rendered the listing standards more permissive, but most of them were stricter in terms of investor protection than the original requirements.[214] Since 2005, however, the number of New Market firms has risen more than five-fold, which might obstruct further substantial revisions.[215] Indeed, the reform process is already running behind schedule, and BM&F Bovespa representatives have signaled that the large number and heterogeneity of New Market firms is a hurdle to sweeping changes to the listing standards. The results remain to be seen.

4. Political Independence

Reform through stock exchange listing standards has the advantage that it does not depend on affirmative legislative action. Indeed, its contractual character may help insulate it from political interference -- an important safeguard given the track records of developing countries (including Brazil) in reversing statutory investor protections. At the same time, it remains within the power of the legislature to rein in the exchange's reforms if they should go too far in threatening established interests and, as we have seen, the Brazilian SEC retains a veto over amendments to the listing standards if they are to apply to companies voting against their adoption.

An important factor here is that the reformist regime itself will have an effect on the character of those established interests, for better or for worse. As we have noted, firms that succeed in attracting capital and growing by virtue of the efficient access to capital markets afforded them by rigorous private-exchange listing standards may, once successful, find that those standards are more helpful to their potential competitors than to themselves, and hence join other established firms in opposing the updating of the standards, or even their continued existence. In short, yesterday's economic insurgents may become today's entrenched elite, re-creating the Olson problem.[216]

Conversely, and more hopefully, the firms that succeed by virtue of the new standards may add to the political constituency supporting reform, as will the economic growth that is expected to come from reform. As capital markets become larger and more efficient, the number and size of the actors with a stake in their success – which include not only new companies and their investors, but also corporate lawyers, accountants, investment bankers, and corporate governance consultants -- grows as well.[217] And as the general population benefits from economic growth, reform may gain

[214] The stricter amendments, effective as of January 2006, required a minimum 20% representation of independent directors in the board of directors of New Market firms; monthly disclosure by BM&F Bovespa of transaction with firm shares by employees, managers and directors (but by group, and not by individuals); and the disclosure of the names of companies subject to sanctions for violation of the New Market standards (the São Paulo Stock Exchange was previously authorized to disclose only the aggregate amount of issued notices and fines). The changes also made clear that, following the 2001 statutory reform, the choice of arbitration for dispute resolution is binding not only on the firm, but also on all of its shareholders. However, the changes also relaxed some of the initial New Market standards, as they eliminated the requirement for a public share distribution for a New Market listing and extended the period to attain a 25% minimum free float.

[215] *See* Part II(b) *supra*.

[216] George Orwell highlighted the problem in the closing scene in Animal Farm; it became difficult to tell the pigs from the farmers. GEORGE ORWELL, ANIMAL FARM c. 10 (1945).

[217] *See, e.g.*, John C. Coffee, Jr., *The Rise of Dispersed Ownership*: *The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1 (2001) (noting the reverse causality between capital

support from broader constituencies. As a consequence, the creation of a privately-organized dual regulatory regime may lead to broader reform through the legislative process, allowing a jurisdiction to break with the path-dependent nature of corporate law rules as an obstacle to capital markets development.[218] In effect, successful reform catalyzes further reform.

Brazil has in fact seen positive legal and regulatory changes following the success of the New Market, which plausibly were reinforced by Brazil's overall favorable economic performance during this period. These important changes apply both to old and new companies, and came rather sooner than the incumbent firms might have anticipated when the New Market experiment was launched in 2000. The Corporations Law was amended once again in 2007 to force convergence of the relatively lax local accounting standards with International Accounting Principles.[219] The Brazilian Securities and Exchange Commission (CVM) has also increasingly advanced the investor protection agenda. Among other things, it issued an opinion suggesting that the discharge of directors' fiduciary duties in freeze-out mergers may require the formation of a special committee of independent directors and majority-of-the-minority approval requirements.[220] In other words, the controlling shareholder was forced to give up its premium, just the kind of wealth transfer the fear of which contributed to the Olson problem in the first place. The Commission has recently showed that its guidelines have teeth when it questioned the procedures followed by the special committees to appraise the appropriate conversion ratio in a merger transaction; following the CVM's negative reaction, the merging parties decided to abandon the initially proposed discount to preferred shares, which were treated on a par with common shares in connection with the transaction.[221] Moreover, the CVM has recently revised its disclosure regulations, which are now stricter than the New Market standards and are expected to mitigate the existing lack of transparency about executive compensation in Brazil.[222] Likewise, since the launch of the Neuer Markt, and especially after its collapse, Germany has enacted various pieces of investor protection legislation.

Regulatory dualism can thus serve as an initially conservative, but ultimately subversive, form of legal change. And as the U.S. experience attests, full convergence to the new regime is not crucial. The goal of the reformist regime is to support economic development by allowing firms that do not yet have access to financing to obtain it. Since the established elites already have financing options, the efficiency consequences of allowing them to keep the old regime for an indefinite time are of a lesser magnitude than they would be in other fields, such as in the case of grandfathering of environmental

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markets developments and investor protection laws, as "strong markets do create a demand for stronger legal rules").

[218] Bebchuk & Roe, *supra* note 75.

[219] Federal Law 11,638/2007. Prior to the reform, *Bovespa*'s premium listing segments required the adoption of either IAS or U.S. GAAP while old firms listed in the traditional generally followed the laxer Brazilian GAAP.

[220] CVM Advisory Opinion 35/2008.

[221] Yuki Yokoi, *Happy Preferred Shareholders: Under CVM Pressure, Aracruz PN and ON Get Equal Treatment in VCP Merger*, 7 REVISTA CAPITAL ABERTO (2009) (describing the process leading to the merger of Aracruz into Votorantim Papel e Celulose in September of 2009). The new company, Fibria, the world's largest pulp and paper company, is expected to migrate to the New Market. *Id.*

[222] CVM Instruction n. 480 (Dec. 7, 2009).

regulations. In fact, that old firms internalize most of the costs associated with the old corporate regime may be one reason why regulatory dualism is more widely employed in contractual areas of the law than in other contexts.

Recognizing the potential for the success of a regulatory dualism strategy to catalyze further reform and thereby accelerate the shifts in wealth and political power that regulatory dualism was intended to moderate raises again the question of why elites did not block reform in the first place. The outcome of the elite's decision calculus[223] is sensitive to a number of variables in addition to the slope of the curve of future reforms and the resulting present value of existing power. For example, those variables interact with the cost of blocking even moderate reform, including the potential for political backlash in the form of comprehensive reform. Of course, the values of these variables are determined by local conditions, with the result that even if a regulatory dualism strategy is the best way to address the Olson problem in a particular country, whether such reform be adopted and succeed depends on the parameter values determined by local conditions. Our analysis indentifies the value of a dual regulatory strategy in the face of the Olson problem. It does not predict the outcome for a particular country.

C. Regulatory Dualism across Federated States

Despite the foregoing, a private regulatory organization within a single state ultimately has only as much autonomy as the government of the state gives it. An alternative form of regulatory dualism that avoids this problem, to a greater or lesser extent, is to have the reformist regime provided by a politically independent foreign government. We have examined two examples of this approach -- the U.S. and the EU -- in the context of a federated union of states. Parallel states within a federal system potentially offer not only a better insulated, but also a more stable and durable, system of regulatory dualism than is available with a private regulatory organization within a single state. In the U.S., for example, regulatory dualism in corporate chartering has been maintained for 135 years.

The presence of an overarching federal government provides two obvious advantages to this form of regulatory dualism. First, the federal government can force the individual states to permit local firms to elect the regulatory regimes of other states. Second, the federal government can mitigate the pathologies of predatory dualism. In particular, they can put a floor on regulatory standards, helping to assure that none of the member states provides a system of regulation that, if chosen by residents of other member states, could impose large external costs upon those states. The U.S. federal government has played this role conspicuously in corporate law by either federalizing, or threatening to federalize, significant elements of corporate and securities law when the principal dual regulatory regime, that of Delaware, has permitted excessive opportunism on the part of controlling shareholders or corporate managers.[224] The extent to which the federal level effectively serves this purpose is contingent both on the structure of a particular federal system and on the politics of the particular circumstance. For example, we have seen that regulatory dualism worked well within the U.S. federal structure with respect to corporate chartering and decidedly less well with respect to bank chartering.

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[223] See TAN 5, supra.
[224] *See* Roe, *supra* note 170.

D. Regulatory Dualism across Independent States

Although federalism can provide a protective context for regulatory dualism, that strategy, as we have seen, can also be implemented across fully independent states. In Brazil, prior to the advent of the New Market, firms seeking access to the capital markets on attractive terms used the United States, with its rigorous securities laws, as their reformist dual regime. This was presumably tolerated by the Brazilian government because it provided a safety valve that released some of the strongest pressures for corporate and capital markets reform in Brazil itself, while at the same time the costs of listing in the U.S. were high enough to limit the number of firms that would take advantage of that opportunity.

The creation of the New Market in Brazil has spurred the creation and growth of corporations in Brazil well beyond what had been achieved simply through access to listings in the U.S., suggesting the superiority, at present, of the former type of regulatory dualism. To be sure, advances in transportation and communication technology are likely to continue to reduce the costs of foreign securities listings and foreign incorporation, making the latter approach increasingly attractive. Yet governments like that of the U.S. have little incentive at present to devote their limited enforcement resources to policing foreign firms, whose transgressions they commonly ignore.[225] Consequently, for the foreseeable future, the Brazilian approach to the regulatory dualism strategy, if it can be managed, may well remain superior to relying on other nations for the reformist regime.

VI. Other Applications of Regulatory Dualism

We have focused here on regulatory dualism as a solution to the Olson problem in corporate and capital markets law. These are not, however, the only field in which regulatory dualism offers a helpful antidote to the Olson problem.

General commercial contracting offers another example. Even within the United States, where the law of commercial contracts is relatively uniform (though still clearly subject to the pressure of established interest groups[226]), New York has emerged as the Delaware of contract law. New York contract law and New York courts are chosen over those of other states, through choice of law and choice of forum clauses, in a striking proportion of important commercial contracts.[227] Outside of the United States, in turn, associations of commercial arbitrators provide a reformist dual regime of contract adjudication for parties from countries with poorly developed law or inefficient courts. And, as a much bolder deployment of regulatory dualism to mitigate the Olson problem in commercial contracting, it has been proposed that, as a solution to the extreme inefficiency and corruption of the courts in many developing (and some developed) countries, merchants who are parties to contracts concerning even purely intra-state transactions be given broad freedom to choose both foreign law and foreign courts to

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[225] *See* Natalya Shnitser, *s*upra note 41. This is particularly true when the foreign listed company has few assets in the United States and therefore is practically immune from private enforcement of the securities law.

[226] Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595 (1995).

[227] *See* Eisenberg & Miller, *supra* note 94.

govern their disputes, rather than making efficiency in contracting await the far distant day when their domestic legal system is finally reformed.[228] A similarly motivated proposal suggests the creation of regional commercial courts as a barrier to existing national elites protecting their interests at the expense of growth through influencing local courts.[229]

We will not further explore here these and other applications of regulatory dualism. Much of what we have said about regulatory dualism as a reform strategy in the context of corporate and capital market law, however, extends to applications of the strategy in other realms as well.

VII. Conclusion: The Promise of Regulatory Dualism

The evolution of corporate law reflects a struggle between allocation and distribution – the conflict presented by reforms that increase production at the expense of making the existing economic and political elites worse off. Regulatory dualism in corporate governance serves to mediate that struggle, providing protection to entrenched owners and managers for the sake of reducing their opposition to the reforms needed to develop an efficient system for financing and managing at least a portion of the corporate sector. Brazil's current experiment with a "New Market" for corporate share listings offers a textbook example of this strategy. But regulatory dualism as a strategy for capital markets reform is not unique to Brazil, nor is it suited just to developing countries. Indeed, the United States has a long and successful record of regulatory dualism in corporate law, and the European Union seems now to have set out on the same path. Germany's conspicuous recent failure with this strategy in its Neuer Market emphasizes the need for care, effective enforcement, and -- as with all human affairs -- luck in its deployment. But with more systematic attention to the means of deploying the strategy, and more attention to the political forces whose opposition to reform it is intended to address, the scope for its successful application may continue to expand. And, as we have only hinted here, regulatory dualism is a development strategy that has application well beyond the problems of corporate and capital market law upon which we have focused.

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[228] Dammann & Hansmann, *supra* note 93.

[229] Ronald J. Gilson & Curtis Milhaupt, *Economically Benevolent Dictators: Lessons for Developing Democracies* (working paper, Dec. 2009).