ONE

Introduction

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

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

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

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

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

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

LAW AND FINANCIAL DEVELOPMENT

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

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

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

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

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

Implicit in the methodological approach used by this literature is the idea that the effects of legal institutions persist over time. If being a civil law country is highly correlated with having smaller financial markets and poorer

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

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

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

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

investor protections today, this relationship should thus be observable at any time in the country's past as well. Even if there is now a larger literature looking at the historical trajectories of institutions and financial development over time, economists and policy makers have largely ignored them, especially when it comes to making policy recommendations. This book contributes to the debate, but rather than focusing only on the evolution of national laws protecting investors, it examines how corporate governance practices evolved at the company level.

ARGUMENT OF THE BOOK

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Incorporation of these investor protections in national laws has been found to be highly correlated with a country's legal tradition.[17] Moreover, countries that follow the common law legal tradition currently provide stronger protections for investors than do countries that follow any of the

[14] La Porta et al., "Investor Protection and Corporate Governance," p. 5.
[15] See Paul Gompers, Joy Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," *Quarterly Journal of Economics* 118, 1 (February 2003): 107–155.
[16] La Porta et al., "Legal Determinants of External Finance" and "Law and Finance."
[17] This argument was initially developed in La Porta et al., "Legal Determinants of External Finance," "Law and Finance," and "Investor Protection and Corporate Governance."

three civil law traditions (French, German, and Scandinavian), and currently French civil law countries have been observed to have the worst protections for investors and smallest financial markets.[18] "[C]ommon law countries give both shareholders and creditors – relatively speaking – the strongest, and French civil law countries the weakest, protections. German civil law and Scandinavian civil law countries generally fall between the other two."[19] Common law countries also have been found to have more developed equity and debt markets than do any of the civil law countries, and French civil law countries have the least developed financial markets, no matter what measure of financial development is used. A description of the basic features of each of the legal families is in Table 1.1.

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

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

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

18 See, for instance, La Porta et al., "Law and Finance," Tables 2 and 4.
19 See, for instance, La Porta et al., "Law and Finance," p. 1116.
20 La Porta et al., "Corporate Ownership around the World."

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

Legal tradition	Main features
French civil law	Legal family in which the application of the law is based on the rules established in codes and statutes that were created by legislatures.[a] This form of civil law emerged after the French Revolution and is based on the codification of Roman law by Justinian (6 A.D.), who "took the view that what was in his compilation would be adequate for the solution of legal problems without the aid of further interpretations or commentary by legal scholars."[b] This legal system was also reaction to the power that French judges had before the French Revolution. According to comparative lawyer John H. Merryman: "Before the French Revolution, judicial offices were regarded as property that one could buy, sell, and leave to one's heir on one's death," and "judges were an aristocratic group who supported the landed aristocracy against the peasants and the urban working and middle classes, and against the centralization of governmental power in Paris."[c] Thus, Napoleon, in an attempt to put the state above the courts, suppressed the lawmaking capacity of judges and limited their discretion to the pure application of what was in the codes and statutes passed by legislatures. As a way to reduce judge discretion and corruption, these reforms also included more procedural formalism that in the long run generated an inefficient legal system.[d] Different codes were passed during the Napoleonic era and the French civil law tradition was diffused to other parts of the world throughout the nineteenth century by colonization and cultural influence, reaching the Near East, some parts of Africa, Indochina, Oceania, the French Caribbean, some Swiss cantons, and Luxembourg. Other areas of influence were Spain, Italy, Belgium, Portugal, and their colonies.
German civil law	This legal family was part of Bismarck's effort to unify the legal system of Germany after 1871. Most of the codes were created in the next two decades, mostly modifying the main procedures of French civil law but allowing jurisprudence a more central role. It was created with the idea that "lawyers would be needed" and that "they would engage in interpreting and applying the law, and that the code they prepared should be responsive to the needs of those trained in the law."[e] German civil law, then, intended to incorporate the principles of German legal tradition, which gave much weight to interpretation of the law and precedent (very much in the spirit of common law) and the principles of French civil law and the Roman tradition with comprehensive codes to regulate all areas of law. This legal tradition prevails in Germany, Austria, Czechoslovakia, Greece, Hungary, Switzerland, Yugoslavia, Japan, Korea, China, and Taiwan.