This book is a detailed historical description of the evolution of corporate governance and stock markets in Brazil in the late nineteenth and twentieth centuries. The analysis details the practices of corporate governance, in particular the rights that shareholders have had to restrict the actions of managers, and how that shaped different approaches to corporate finance over time. The book argues that companies are not necessarily constrained by the institutional framework in which they operate. In the case of Brazil, even if the protections for investors included in national laws were relatively weak before 1940, corporate charters contained a series of provisions that protected minority shareholders against the abuses of large shareholders, managers, or other corporate insiders. These provisions ranged from limits on the number of votes a single shareholder could have to restrictions on the number of family members who could act as directors simultaneously. The investigation uses the Brazilian case to challenge some of the key findings of a recent literature that argues that legal systems (e.g., common vs. civil law) shape the extent of development of stock and bond markets in different nations. The book argues that legal systems alone cannot determine the course of stock and bond markets over time, because corporate governance practices and the size of these markets vary significantly over time, while the basic principles of legal systems are stable.

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Continued after the index
Experiments in Financial Democracy

Corporate Governance and Financial Development in Brazil, 1882–1950

ALDO MUSACCHIO
Harvard Business School
Para Haydeé y Humberto
... most of the fundamental errors currently committed in economic analysis are due to lack of historical experience more often than to any other shortcoming of the economist's equipment.


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

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

List of Figures and Tables   page xi
Preface                     xv
Acknowledgments             xxi

1 Introduction             1
2 Financial Development in Brazil in the Nineteenth Century 28
3 The Stock Exchange and the Early Industrialization of Brazil, 1882–1930 58
4 The Foundations of Financial Democracy: Disclosure Laws and Shareholder Protections in Corporate Bylaws 84
5 Voting Rights, Government Guarantees, and Ownership Concentration, 1890–1950 105
6 Directors, Corporate Governance, and Executive Compensation in Brazil, c. 1909 135
7 Bond Markets and Creditor Rights in Brazil, 1850–1945 155
8 Were Bankers Acting as Market Makers? 186
9 What Went Wrong after World War I? 215
10 The Rise of Concentrated Ownership in the Twentieth Century 236
11 Conclusion             253

Bibliography               267
Index                      289
Figures and Tables

FIGURES

2.1. Number of new domestic joint stock companies and banks registered in Brazil, 1848–1909 page 35
2.2. Equity market capitalization over GDP in Brazil (five-year intervals), 1878–2002 41
2.3. Stock turnover at the Rio de Janeiro Stock Exchange (as a % of GDP), 1894–1980 44
2.4. Turnover of securities in the Rio de Janeiro Stock Exchange, 1894–1930 (contos de mil reis [millions] of 1900) 45
2.5. Stock of bonds (debentures) relative to GDP in Brazil, 1886–2002 46
2.6. Volume of debentures traded (as a % of GDP) 47
2.7. Corporate bond issues per year, Rio de Janeiro Stock Exchange, 1890–1930 49
3.1. Net flows of bank credit and net changes in private securities outstanding, 1906–1930 65
4.1. Shareholder rights and average stock market capitalization to GDP, 1890–2003 89
7.1. Total corporate bankruptcies and cases used 174
9.1. British capital exports to the private sector in Brazil, 1870–1939 (as a % of Brazil's GDP, three-year moving average, net values after 1924) 219
9.2. British capital exports to the private sector in Brazil, 1870–1939 (by sector, as a % of Brazil's GDP, net values after 1924) 220
9.3. Stock and bond market capitalization to GDP, Brazil, 1881–2003 220
List of Figures and Tables

9.4. Volume of stocks and corporate bonds traded relative to GDP, 1894–1969 223
9.5. Capital flows to Brazil (from England) and stock and corporate bonds turnover (all relative to GDP, indices with 1913=100), 1894–1939 224
9.6. Nominal and real average yields of stocks and corporate bonds, Brazil, 1905–1942 226

TABLES

1.1. Main features of the four legal families according to the law and finance literature 10
1.2. Comparison of the sources of shareholder protections in law and finance vs. practice and finance 19
1.3. Main differences between the law and finance and corporate and finance approaches 23
2.1. Trading and chartering requirements for corporations in Brazil, 1850–1891 33
2.2. Number of companies registered at the exchange (per million population, averages by decade) 37
3.1. Total loans, equity, and bonds outstanding per year, 1906–1930 (as a % of GDP) 64
3.2. Total loans to GDP in selected countries, 1895–1929 66
3.3. Granger causality tests of financial development and real GDP levels, 1906–1930 and 1896–1930 69
3.4. Capitalization of the Rio de Janeiro Stock Exchange by type of security (at face value, in thousand contos of mil reis of 1900) 71
3.5. Number of companies traded on the Rio de Janeiro Stock Exchange, 1896–1930 73
3.8. Average turnover rates per year for traded companies, Rio de Janeiro Stock Exchange, 1896–1930 78
### List of Figures and Tables

<table>
<thead>
<tr>
<th>Figure/Table</th>
<th>Title</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.9</td>
<td>Number of companies traded on the São Paulo Stock Exchange, 1902–1917</td>
<td>80</td>
</tr>
<tr>
<td>3.10</td>
<td>Stock market capitalization by industry, São Paulo Stock Exchange, 1902–1917</td>
<td>81</td>
</tr>
<tr>
<td>4.1</td>
<td>Shareholder rights in Brazil and England, 1882–2001</td>
<td>87</td>
</tr>
<tr>
<td>4.2</td>
<td>Voting rights in Brazilian corporations, c. 1909</td>
<td>100</td>
</tr>
<tr>
<td>5.1</td>
<td>Summary statistics: ownership data, Brazil, 1890–1950</td>
<td>109</td>
</tr>
<tr>
<td>5.2</td>
<td>Correlates of governance and ownership concentration using a Tobit estimate, Brazil, 1890–1950</td>
<td>112</td>
</tr>
<tr>
<td>5.3</td>
<td>Correlates of governance and ownership concentration using OLS, Brazil, 1890–1950</td>
<td>114</td>
</tr>
<tr>
<td>5.4</td>
<td>Voting groups at the E. F. Paulista shareholder meeting, 1935</td>
<td>119</td>
</tr>
<tr>
<td>5.5</td>
<td>Evolution of ownership concentration and control in Brazil, 1890–2004</td>
<td>125</td>
</tr>
<tr>
<td>5.6</td>
<td>Ownership concentration in some of Brazil’s largest corporations</td>
<td>127</td>
</tr>
<tr>
<td>6.1</td>
<td>Management composition and incentive structure in Brazilian corporations (by industry), c. 1909</td>
<td>138</td>
</tr>
<tr>
<td>6.2</td>
<td>Median profit rates (to capital) by industry, Brazil, c. 1909</td>
<td>141</td>
</tr>
<tr>
<td>6.3</td>
<td>Estimated CEO total compensation by industry and region, Brazil, c. 1909 (current US$)</td>
<td>142</td>
</tr>
<tr>
<td>6.4</td>
<td>Total executive compensation in manufacturing companies in Brazil, c. 1909, and the United States, 1904–1914 (annual salary in current US$)</td>
<td>143</td>
</tr>
<tr>
<td>6.5</td>
<td>Summary statistics and difference of means for CEO compensation variables, Brazil, c. 1909</td>
<td>149</td>
</tr>
<tr>
<td>6.6</td>
<td>Regressions CEO compensation estimates (normalized by size), Brazil, c. 1909</td>
<td>151</td>
</tr>
<tr>
<td>7.1</td>
<td>Debentures relative to capitalization</td>
<td>158</td>
</tr>
<tr>
<td>7.2</td>
<td>Total debenture stock by industry, Brazil, 1881–1925</td>
<td>159</td>
</tr>
<tr>
<td>7.3</td>
<td>Percentage of firms that issued debentures by sector, 1881–1931</td>
<td>160</td>
</tr>
<tr>
<td>7.4</td>
<td>Bond-equity ratios for debenture-issuing companies</td>
<td>161</td>
</tr>
<tr>
<td>7.5</td>
<td>Creditor rights in Brazil since 1850</td>
<td>163</td>
</tr>
<tr>
<td>8.1</td>
<td>Number of interlocking boards of directors by industry in Brazil, c. 1909</td>
<td>198</td>
</tr>
<tr>
<td>8.2</td>
<td>Number of interlocking boards of directors by industry in Mexico, c. 1909</td>
<td>199</td>
</tr>
</tbody>
</table>
### List of Figures and Tables

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.3</td>
<td>Bankers in the networks of corporate interlocks in Brazil, Mexico, the United States, and Germany, c. 1910</td>
<td>201</td>
</tr>
<tr>
<td>8.4</td>
<td>Most central corporations in the United States, degree and Bonacich centrality, 1904 and 1928</td>
<td>204</td>
</tr>
<tr>
<td>8.5</td>
<td>Most central corporations in Mexico, Bonacich centrality, 1909</td>
<td>205</td>
</tr>
<tr>
<td>8.6</td>
<td>Most central corporations in Mexico, betweenness centrality, 1909</td>
<td>206</td>
</tr>
<tr>
<td>8.7</td>
<td>Most central corporations in Brazil, Bonacich centrality, 1909</td>
<td>207</td>
</tr>
<tr>
<td>8.8</td>
<td>Most central corporations in Brazil, betweenness centrality, 1909</td>
<td>208</td>
</tr>
<tr>
<td>8.9</td>
<td>Summary statistics, corporate network and bank interlocks data, Brazil and Mexico, c. 1909</td>
<td>210</td>
</tr>
<tr>
<td>8.10</td>
<td>Correlates of company-bank interlocks in Brazil and Mexico (OLS and Probit estimates), c. 1909</td>
<td>211</td>
</tr>
<tr>
<td>10.1</td>
<td>Total bank loans for the private sector (as a % of GDP), 1951–1972</td>
<td>239</td>
</tr>
<tr>
<td>10.2</td>
<td>New stock and bond issues (as a % of GDP), Brazil, 1951–1972</td>
<td>241</td>
</tr>
<tr>
<td>10.3</td>
<td>Ownership of the largest business groups in Brazil, 1980</td>
<td>244</td>
</tr>
</tbody>
</table>
When I started to do research for this book, debate about the policies and legal institutions necessary for the development of financial markets around the world was intensifying both in academic circles and in international financial agencies. As academics reached near consensus on the importance of financial development to foster economic growth, the development of financial markets became a goal of international development agencies and governments in most countries. Discussion moved from how important it was to have stock markets versus banks to how countries could develop financial markets in general. To devise policies that could help countries develop financial markets, however, academics and policy makers first had to understand why financial markets are more developed in some countries than in others.

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

Researchers therefore sought to explain the variance in financial markets by looking for institutional differences across countries that would not be a consequence of financial market development. The logical way to do this was to go back in history before the emergence of modern financial markets to look for factors that might account for the variation in institutions across countries.
A number of papers that follow this methodological approach argue that contemporary institutional and financial outcomes are a consequence of the persistent effects of the legal traditions countries adopted decades or centuries ago. This literature, termed the “law and finance” literature, advances the idea that a country’s legal tradition determines the degree to which the legal system protects investors from the abuses of managers and corporate insiders, and how willing savers are to participate in financial markets and, ultimately, how deep these markets will be. In fact, their statistical work suggests that common law countries (Australia, Canada, England, the United States, and others) have, on average, stronger protections for creditors and shareholders, and larger financial markets, than countries that followed the civil law tradition (Brazil, countries in continental Europe, most of Latin America, and others).

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

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

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

The answer, I found, was that the investor protections absent from national laws were incorporated in the bylaws or provided through the actions of corporations and the information made available to investors before equity was sold in financial markets. I found this also to be the case in other countries in which national protections for investors were weak or absent. For instance, while I was writing this book researchers studying the evolution of stock markets and ownership concentration in Chile, Germany, Italy, Japan, and the United Kingdom showed that in those countries, too, financial markets had grown rapidly at the end of the nineteenth century and beginning of the twentieth century despite the lack of legal protections for shareholders in national laws. Some of these researchers surmised that financial intermediaries such as universal banks and stock exchanges were the source of the trust needed to induce investors to buy the equity and participate in the ownership of publicly traded corporations. The evidence for Chile, England, and Japan was to a large extent similar to that for Brazil: corporations included in their bylaws voting provisions that explicitly protected small investors by limiting, for example, the maximum number of votes per shareholder.
The idea that the kind of investor protections we observe today is a consequence of the legal tradition countries follow stems directly from the way the law and finance literature conceptualizes history. If there are clear and systematic differences in legal protections for investors across countries, and those are strongly correlated with legal origin, then in order to justify the causality from those protections to financial development it must be the case that the systematic differences were determined by legal origin years and years ago. Yet, the evidence presented in this book shows that this is not the case: before 1913 investor protections were very different in Brazil, and perhaps in many countries, from what they are today. History did not occur the way the literature assumes and the only way to know the evolution of investor protections over time is actually to do historical work. Therefore, the first main objective of this book is to defend the use of explicit historical research rather than relying on the merely implicit historical work done by most studies in the law and finance literature. As Joseph Schumpeter argued in his *History of Economic Analysis*, perhaps this is one of those instances in which the use of detailed historical work could aid the development of an economic theory of the relationship between legal institutions and financial development.

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

My historical evidence shows that in the absence of investor protections in national laws, Brazilian companies and their founding shareholders induced smaller investors to buy equity on a massive scale before 1915 through the dissemination of information (e.g., the names and interests of
Preface

all corporate insiders) and inclusion of friendly provisions in their bylaws. I document, for example, some important provisions in corporate bylaws that limited the power of large shareholders and show how they operated in practice. In fact, corporations with provisions that limited the power of large shareholders exhibited less concentration of ownership and voting power. I found many instances of shareholders who held large portions of equity that afforded them less than proportional voting rights, reflecting, I believe, democratic attitudes on the part of investors and a rooted tradition of “financial democracy” in some of Brazil’s largest corporations.

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

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

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

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

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