

ARTICLES

REGULATORY DUALISM AS A DEVELOPMENT STRATEGY: CORPORATE REFORM IN BRAZIL, THE UNITED STATES, AND THE EUROPEAN UNION

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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 development. Controlling owners and managers of established firms successfully oppose corporate governance reforms that would improve investor protection and promote capital market growth. In this Article, we examine the promise of regulatory dualism as a strategy to defuse 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 dy-

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namic 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 Novo Mercado (New Market), 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 incorporating a form of regulatory dualism than—as is the custom—as an example 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 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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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 that, having achieved economic success and therefore political influence 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 body of empirical evidence suggest that economic development 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

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

1. A large body of literature has sought to demonstrate the positive influence of financial development on overall economic growth. *See, e.g.*, Valentina Bruno & Stijn Claessens, *Corporate Governance and Regulation: Can There Be Too Much of a Good Thing?*, 19 J. FIN. INTERMEDIATION 461, 479 (2010) (finding that companies with good corporate governance rely more heavily on external finance); Robert G. King & Ross Levine, *Finance and Growth: Schumpeter Might Be Right*, 108 Q.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); Asli Demirguc-Kunt & Ross Levine, *Finance and Inequality: Theory and Evidence* 2-3 (Nat'l Bureau of Econ. Research, Working Paper No. 15,275, 2009), available at <http://www.nber.org/papers/w15275.pdf> (reviewing the literature on finance and inequality, and finding strong evidence that financial development helps improve economic opportunity and reduce inequality).

2. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert 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 La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000) [hereinafter La Porta et al., *Investor Protection and Corporate Governance*]; La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998); and La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997). Admittedly, the strength of these empirical results has been questioned. *See, e.g.*, Holger Spamann, *The "Antidirector Rights Index" Revisited*, 23 REV. FIN. STUD. 467 (2010).

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. These and other law-and-finance claims are not relevant to the problem we address here.

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 overcome the Olson problem—that is, to defuse 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—that 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*.

Regulatory dualism seeks to avoid, or at least mitigate, the Olson problem by permitting the existing business elite to be governed by the prereform regime, while pursuing development by allowing other businesses to be governed by a reformed regime. Put in terms of capital market and shareholder protection, regulatory dualism 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 established elites, while more effective shareholder protection

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 S. 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 G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5 (2003).

4. See OLSON, *supra* note 3, at 77.

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* 33-34 (2006).

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makes public financing available to the entrepreneurial sector, thereby expanding the capital market's capacity to support economic development.⁶

To be sure, regulatory dualism is not without costs to the elites. However, the two more extreme alternatives—comprehensive reform and no reform—also impose costs on the elites. 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 ultimately produce a popular backlash that seriously damages the overall economic and political position of the current elites.

Given the alternatives, regulatory dualism can provide an attractive compromise 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

Our particular focus here is on dual regulatory regimes as a solution to the Olson problem. Multiple regulatory regimes can play other roles as well. In particular, it is helpful to distinguish what we term regulatory dualism from

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. See Lucian A. Bebchuk & Zvika Neeman, *Investor Protection and Interest Group Politics*, 23 REV. FIN. STUD. 1089, 1089, 1091 (2010). 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 their strategic calculus. As should already be apparent, the outcome of that calculus will depend heavily on local factors; while the structure of the analysis is general, the parameter values will depend on a country's particular circumstances. See *infra* Part IV.D.

regulatory diversification, regulatory experimentation, and regulatory competition. For clarity, we offer characterizations here—in sharply delineated, ideal type terms—of each of these four rationales for maintaining multiple regulatory regimes.

Regulatory Diversification. The actors being regulated are not homogeneous in their needs for regulation. Consequently, it is efficient to maintain two or more parallel regimes of regulation, with each regime designed to deal with the particular characteristics of a distinct set of actors.

Regulatory Experimentation. The actors being regulated may or may not be homogeneous. It is unclear what form of regulation is most efficient, or perhaps even whether efficiency calls for one regime or multiple regimes. For this reason, alternative experimental regulatory regimes are created, either in different jurisdictions or in a single jurisdiction, and then compared to see which function best, with an eye to replicating, ultimately, the best regime(s). The Brandeisian notion of federated states as laboratories of democracy reflects this approach to regulation.

Regulatory Competition. The actors being regulated are relatively homogeneous, with the consequence that a single regulatory regime would, in principle, be most efficient. But—perhaps owing to laxity, self-interest, ignorance, or ideology—a single agency with a monopoly on regulatory authority cannot be trusted to adopt the efficient form of regulation. The regulated actors have an incentive to be governed by an efficient regulatory regime—for example, so that they can attract patrons, such as investors, workers, or customers. Creating multiple regulators with overlapping jurisdictions, so that the regulated actors can choose the regulatory regime to which they will be subject, puts the various regulators in competition with each other as they seek to attract, or not to lose, actors subject to their system of regulation.

Regulatory Dualism. As with regulatory competition, a single homogeneous regulatory regime for all actors would in principle be most efficient. Here, however, the preexisting system of regulation—the established regime—has been captured by a subset of the actors that it regulates and inefficiently permits those actors to pursue their private interests. A second, more efficient system of regulation—the reformist regime—is created, and is made available to all actors. Meanwhile, the established regime is maintained and is also made available to all actors, whether they have previously been governed by that regime or not. Maintaining the established regime reduces the incentive for those who benefit from that regime to oppose creation of the reformist regime.

An important difference between regulatory competition and regulatory dualism—in the ideal types we have defined here—is that regulatory competition causes the various regulatory regimes to converge toward the efficient regime, while under regulatory dualism the alternative regulatory regimes remain divergent. Indeed, under regulatory dualism, the introduction of the reformist regime may actually cause the established regime to become even *less* efficient

than it would be if it were the sole regime, since the reformist regime draws off some of the constituency for reform of the established regime. Thus, in contrast to regulatory competition, regulatory dualism creates a dynamic in which the choice between two regimes of differing efficiency actually *reduces* rather than *increases* pressure to reform the less efficient (established) regime. Put in Albert Hirschman's famous terms, the opportunity to exit to the reformist regime softens the voice calling for reform of the established regime.⁸ But, in appropriate circumstances, this tradeoff promises substantial net gains in efficiency.

Regulatory diversification, regulatory experimentation, regulatory competition, and regulatory dualism are not mutually exclusive. All four can be present to some degree when actors are given a choice concerning the regulatory regime that will govern them. Perhaps for this reason, the extensive literature that addresses what is loosely termed *regulatory competition*—including the conspicuous subset of that literature that focuses on corporate chartering—does not always deal just with regulatory competition of the ideal type we define above, but also or instead deals with phenomena that are better described as regulatory diversification, regulatory experimentation, or regulatory dualism.

Our principal objective here is to identify and analyze regulatory dualism as a phenomenon distinct from—and arguably as important as—regulatory competition. We introduce the concept of regulatory dualism by examining a strikingly clear example of it, in the form of 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 preexisting exchange institutions and regulations. The Novo Mercado, whose listing standards offer far more protection to noncontrolling shareholders than does the old regime, is open, on a voluntary basis, to both new and existing firms that are prepared to comply with its requirements. Meanwhile, the old regime remains available to both old and new firms as well.

While Brazil's Novo Mercado is a paradigmatic example of regulatory dualism, it is far from the only example. Germany, for instance, tried a stock exchange scheme similar to Brazil's in the late 1990s, only to abandon it as a dramatic failure a few years later. The European Union's recent steps toward permitting greater choice of jurisdiction for incorporation also has much of the character of regulatory dualism, leaving established firms to be governed by the preexisting 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 an alternative regulatory regime.

Moreover, corporate chartering in the United States, long analyzed as an example of regulatory competition, has strong elements of regulatory dualism as well. In the United States, controlling shareholders and managers desiring a

8. ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 4-5 (1970).

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. Thus, 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.

Our exposition proceeds as follows. Part I describes Brazil's recent efforts to reform its equity markets, after decades of political paralysis, through the alternative Novo Mercado created within the established stock exchange. Part II describes other efforts at regulatory dualism, including the premium stock exchange segment created in Germany with the Frankfurt *Neuer Markt* (New Market), as well as the systems of corporate chartering adopted in the European Union and the United States. Part III compares regulatory dualism with related regulatory strategies such as grandfathering, statutory menus, and default rules. Part IV explores alternative sources for the reformist regime, from private regulatory organizations to independent foreign states.

I. BRAZIL'S NOVO MERCADO

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 Novo Mercado experiment was deliberately designed to circumvent the political clout of established firms in obstructing legislative reform that was badly needed to improve minority investor protection.

A. *Brazil Before the Novo Mercado*

Throughout the twentieth century, Brazil was a textbook example of the Olson problem. An established economic elite, in control of the nation's leading companies, repeatedly frustrated efforts at corporate law reform that would offer new firms better access to capital markets.

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,

9. *But see* Aldo Musacchio, *Law Versus Contracts: Shareholder Protections and Ownership Concentration in Brazil, 1890-1950*, 82 *BUS. HIST. REV.* 445, 448-49 (2008) (noting that Brazil experienced a period of fairly developed capital markets between 1890 and 1914).

Brazilian corporations relied largely on retained earnings, government and bank loans, and, for a handful of large conglomerates, extrajurisdictional financing in foreign currency.¹⁰ Smaller firms were therefore capital constrained, having to rely on bank loans at high interest rates and with short maturities as their principal source of financing. Brazilian economists and policymakers long argued that this scarcity of long-term capital took a substantial toll on development.¹¹

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.¹² Nevertheless, when the military government undertook to promote capital market development in the 1960s, it adopted an all-carrot-no-stick strategy that granted generous tax incentives to publicly traded firms and their investors without implementing substantive legal improvements in shareholder rights.¹³ 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.¹⁴

10. See, e.g., MB ASSOCIADOS, DESAFIOS E OPORTUNIDADES PARA O MERCADO DE CAPITAIS BRASILEIRO [CHALLENGES AND OPPORTUNITIES FOR BRAZILIAN CAPITAL MARKETS] (2000), available at http://www.bmfbovespa.com.br/Pdf/mercado_capitais_desafios.pdf (noting the historical insignificance of Brazilian capital markets and the prominent role of governmental loans as a source of long-term financing).

11. See, e.g., SOLUÇÕES PARA O DESENVOLVIMENTO DO MERCADO DE CAPITAIS BRASILEIRO [SOLUTIONS FOR THE DEVELOPMENT OF BRAZILIAN CAPITAL MARKETS] 28 (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. See, e.g., MÁRIO HENRIQUE SIMONSEN, BRASIL 2002, at 124 (1972) (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); FUNDAÇÃO GETÚLIO VARGAS, A MISSÃO COOKE NO BRASIL [THE COOKE MISSION IN BRAZIL] 91 (1949) (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).

13. For a detailed description of the tax incentive policies adopted in Brazil, see David M. Trubek, *Law, Planning, and the Development of the Brazilian Capital Market*, BULLETIN (N.Y.U. Graduate Sch. of Bus. Admin. Inst. of Fin.), nos. 72-73, 1971.

14. See, e.g., David M. Trubek, *Toward a Social Theory of Law: An Essay on the Study of Law and Development*, 82 YALE L.J. 1, 45-46 (1972) (noting that although it was the case 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 of the private rights 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 generally Julian Franks et al., *The Origins of the German Corporation—Finance, Ownership and Control*, 10 REV. FIN. 537, 538-39 (2006) (describing the evolution of corporate ownership structures in Germany); Julian Franks et al., *Spending Less Time with Family: The Decline in Family Ownership in the United Kingdom*, in A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 581 (Randall K. Morck ed., 2005) (describing the timing of dispersal of family shareholdings in the United Kingdom).

However, these policies not only failed to establish sustainable capital markets, but they also erected hefty barriers to future law reforms. The tax incentives for share issuance caused virtually all firms going public in the 1960s and 1970s to have, in addition to a controlling shareholder, a large base of public shareholders owning mostly nonvoting preferred stock or minority common stock.¹⁵ The result was to give controlling shareholders a strong vested interest in opposing legal reforms that improved minority protections. Thus, in 1971 the controlling shareholders of publicly traded firms founded the Brazilian Association of Public Companies, a lobbying group that would become highly successful in opposing investor protection reforms.¹⁶

Although legal reform to support capital market development remained on the government's public agenda, the reform that occurred was ineffective. Although the 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,"¹⁷ its overall contribution to minority protection was modest. The new law in fact conceded to demands of controlling groups by *increasing* the existing ceiling for the issuance of nonvoting preferred shares from one-half to up to two-thirds of the firm's total equity capital and restricting the scope of a new mandatory bid requirement (so-called tag-along rights) for voting shares in the event of a change of control.¹⁸ In 1997, a government-sponsored reform to the Corporations Law eliminated even the limited statutory protections then available to minority shareholders upon control sales, such as statutory appraisal rights at book value and the weakened manda-

15. Since 1932, Brazilian firms were permitted to issue nonvoting stock so long as these securities provided either a dividend or a liquidation preference vis-à-vis common stock. In many firms, nonvoting preferred shares only had a liquidation preference. See Lei No. 6.404, de 15 de Dezembro de 1976, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 17.12.1976, art. 17. It was not until the legal reforms of 1997 and 2001 that Brazilian corporations were required to grant more substantial preferences (such as favorable dividend treatment or tag-along rights) to preferred nonvoting shares. See Lei No. 10.303, de 31 de Outubro de 2001, D.O.U. de 1.11.2001, art. 2; Lei No. 9.457, de 5 de Maio de 1997, D.O.U. de 6.5.1997, art. 1. For a survey of the ownership structure of publicly traded Brazilian corporations in the 1970s, see Comissão de Valores Mobiliários, *Valor de Mercado do Capital das Companhias Abertas Brasileiras* [Market Capitalization of Brazilian Publicly Traded Companies], 4 REVISTA BRASILEIRA DO MERCADO DE CAPITAIS 283, 292 (1978) (finding that listed companies in Brazil typically had a controlling shareholder holding a majority of the company's voting stock).

16. See *infra* notes 30, 209, and accompanying text; see also Luciano Coutinho & Flavio Marcilio Rabelo, *Brazil: Keeping It in the Family*, in CORPORATE GOVERNANCE IN DEVELOPMENT 35, 49 (Charles P. Oman ed., 2003) (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).

17. Lei No. 6.404, de 15 de Dezembro de 1976, D.O.U. de 17.12.1976 as amended. Lei No. 6.404 remains Brazil's principal corporate law statute.

18. For a critique of the 1976 Corporations Law, see MODESTO CARVALHOSA, A NOVA LEI DAS SOCIEDADES ANÔNIMAS [THE NEW CORPORATIONS LAW] 11-17 (1977).

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tory bid rule, in order to allow the federal government to maximize its privatization proceeds.¹⁹

By promoting acquisitions without exit opportunities for the minority, the abolition of the mandatory bid rule exposed the serious deficiencies in the legal protection of minority shareholders in case of freezeouts and going-private transactions. As a result, many companies went private through the payment of offer prices below the book value of the company.²⁰ A subsequent estimate indicated that Brazil had the highest levels of private benefits of control among thirty-nine countries surveyed for the decade between 1990 and 2000.²¹

By the turn of the century, the prospects for Brazilian capital markets looked increasingly grim. Between 1995 and 2000, only eight companies had launched an initial public offering (IPO) on the São Paulo Stock Exchange (*Bolsa de Valores de São Paulo-Bovespa*), later renamed BM&F Bovespa, then Brazil's only operating stock exchange.²² At the time, the São Paulo Stock Exchange was a mutual organization owned by brokerage firms, which had an incentive to maximize both the trading volume and the prices of the securities traded.²³ Following a study by prominent Brazilian economists commissioned by the São Paulo Stock Exchange,²⁴ the Exchange confronted the fact that inaction both by it and the legislature threatened the very survival of Brazilian capi-

19. See Lei No. 9.457, de 5 de Maio de 1997, D.O.U. de 6.5.1997. For an examination of the role of the government as a shareholder in shaping corporate law reforms in Brazil and elsewhere, see Mariana Pargendler, *State Ownership and Corporate Governance* 13-22 (Jan. 2011) (unpublished manuscript) (on file with authors).

20. See Maria Helena Santana, *The Novo Mercado*, in *NOVO MERCADO AND ITS FOLLOWERS* 1, 9-10 (2008).

21. Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 554-56 (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 one-third of the value of the company by holding as little of one-sixth of total cash flow rights. Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325, 327 (2003).

22. Santana, *supra* note 20, at 7. The São Paulo Stock Exchange was established in the late nineteenth century and was rivaled in importance by the Rio de Janeiro Stock Exchange for most of the twentieth century. In the late 1980s, however, the Rio de Janeiro Stock Exchange collapsed and was eventually shut down following a major stock price manipulation scheme. This led to the consolidation of all stock trading on the São Paulo Stock Exchange. In 2008, the São Paulo Stock Exchange merged with the São Paulo Commodities and Futures Exchange (*Bolsa de Mercadorias e Futuros-BM&F*) to form BM&F Bovespa, a publicly traded firm listed on the Novo Mercado.

23. Following an international trend of demutualization of stock exchanges, in 2007 the São Paulo Stock Exchange was transformed into an investor-owned firm and went public on the Novo Mercado. *See id.* at 5.

24. MB ASSOCIADOS, *supra* note 10.

tal markets.²⁵ 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 while 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, a premium exchange listing segment subject to listing requirements that imposed much stricter corporate governance rules than those provided under Brazilian law.²⁶

B. *The Novo Mercado Standards*

When the São Paulo Stock Exchange took up the problem of reform, the contemporaneous success of the Deutsche Börse's initiative with its own "New Market"—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.²⁷ The Brazilian Novo Mercado, 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 Novo Mercado 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 law for publicly traded business corporations. The idea was that a contractual solution would circumvent the persistent legislative capture thwarting legal reform.²⁸

The Novo Mercado listing standards were entirely voluntary. A company had to choose to subject itself to the higher standards; companies were free to remain listed on, or to obtain their initial listing on, the traditional segment. The

25. See Cally Jordan & Mike Lubrano, *How Effective Are Capital Markets in Exerting Governance on Corporations?*, in FINANCIAL SECTOR GOVERNANCE 327, 342 (Robert E. Litan et al. eds., 2002) (describing the creation of the Novo Mercado as a "quasi private effort to make up for the perceived shortcomings of legislative reform").

26. While the Brazilian Congress finally amended the Corporations Law in late 2001, the Olson problem was again apparent: the reform was quite limited. The new statute, Lei No. 10.303, de 31 de Outubro de 2001, D.O.U. de 1.11.2001, continued to permit the issuance of nonvoting preferred shares, but the ratio to total capital was reduced from 66.7% to 50% for new firms. *Id.* at art. 15, § 2. The 2001 law also reintroduced a mandatory bid rule, but only partially: it applied only to common shares and entitled common shareholders to receive only 80% of the price paid for the controlling block. *Id.* at art. 254-A. 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. See Mensagem No. 1.213, de 31 de Outubro de 2001, D.O.U. de 31.10.2001 (describing the reasons for the presidential veto).

27. See *infra* Part II.A.

28. See CALIXTO SALOMÃO FILHO, O NOVO DIREITO SOCIETÁRIO [THE NEW CORPORATE LAW] 58 (3d ed. 2006).

strategy was to attract to the Novo Mercado principally 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 Novo Mercado 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 Novo Mercado 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.²⁹ The Brazilian Association of Public Companies argued that the adoption of “alien” corporate governance standards unsuited to local conditions could harm the performance of Brazilian corporations.³⁰ Yet this reaction from old firms was significantly milder than their successful efforts to block or dilute previous legislative proposals. Lacking the capacity to block reform at an acceptable cost, the old firms acquiesced.

The dual regulatory approach goes a long way in explaining the established firms' complacency vis-à-vis the Novo Mercado. Unlike legislative reform, the Novo Mercado 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 Novo Mercado could in fact serve to reduce the demand for comprehensive statutory reform.³¹ While these firms also feared being stigmatized for “sub-optimal governance” if they failed to embrace the Novo Mercado requirements,³² the fact that the old as well as the new standards remained permissible for both old and new firms somewhat offset the negative connotation.

To be sure, while regulatory dualism prevents the old firms from suffering the adverse distributive consequences of minority protection reforms, it does little to address the competitive threat from capital market development. There are, however, several reasons why the existing Brazilian elite 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 Novo Mercado was an untested experiment and its very potential for success was

29. See Santana, *supra* note 20, at 12.

30. ASSOCIAÇÃO BRASILEIRA DAS COMPANHIAS ABERTAS, RELATÓRIO DA DIRETORIA [ANNUAL MANAGEMENT REPORT] 6 (2005), available at <http://www.abrasca.org.br/aabrasca/Relatorio-Anual-Abrasca-2005.pdf>.

31. Indeed, following the creation of the Novo Mercado the Brazilian Association of Public Companies began to argue that legal reforms banning nonvoting preferred shares were unnecessary precisely because “voluntary market mechanisms” had emerged to address this issue. ASSOCIAÇÃO BRASILEIRA DAS COMPANHIAS ABERTAS, RELATÓRIO DA DIRETORIA [ANNUAL MANAGEMENT REPORT] 24 (2006), available at http://www.abrasca.org.br/aabrasca/Relatorio_Anual_Abrasca_2006.pdf.

32. Santana, *supra* note 20, at 12.

highly uncertain at the outset.³³ Since capital market development is notoriously hard to achieve,³⁴ the political costs of opposing such an improbable project probably seemed larger than the expected benefits. Second, the most influential members of the corporate establishment—large state-owned enterprises and family-controlled conglomerates—were in any case unlikely to be in the same industry and become direct competitors of the medium-sized firms that were initially expected to pursue a Novo Mercado listing.³⁵ Finally, the worldwide opening of trade in recent years exposed established firms to foreign competition, which may have made the reforms more palatable: poor access to capital in Brazil would not inhibit Brazilian firms' foreign competitors, and could hinder established Brazilian firms in confronting that foreign competition.³⁶ All in all, then, the Novo Mercado looked like a relatively unthreatening compromise.

The São Paulo Stock Exchange was sensitive about not unduly upsetting existing firms, which constituted, after all, its principal clientele. Its initial project envisioned the creation of a single alternative regime—the “one share, one vote” Novo Mercado. This proved too demanding, however, for the appetite of most existing companies. A more accommodating solution was consequently settled upon, which involved the creation of a series of three new graduated levels of regulation that culminated in the Novo Mercado (see Table 1). The listing rules of the preexisting basic segment did not impose any corporate governance or disclosure standards beyond those required under Brazilian law.

As adopted, the overall reform encompassed four levels of listing, which offered progressively higher levels of minority shareholder protection: (1) Basic (preexisting corporate and securities law rules); (2) Level 1; (3) Level 2; and (4) Novo Mercado.

33. As described in Part I.D, the Novo Mercado 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 Novo Mercado experiment to its inability to compete with the stronger “reputational brand” of the NYSE. John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1807-08 (2002).

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

35. See MB ASSOCIADOS, O MERCADO DE CAPITAIS BRASILEIRO FRENTE AOS DESAFIOS IMPOSTOS PELAS NEGOCIAÇÕES INTERNACIONAIS EM SERVIÇOS FINANCEIROS [BRAZILIAN CAPITAL MARKETS AND THE CHALLENGES IMPOSED BY INTERNATIONAL NEGOTIATIONS IN FINANCIAL SERVICES] 27 (2004), available at <http://www.bmfbovespa.com.br/Pdf/Estudo2.pdf> (noting that the Novo Mercado initially aimed at attracting medium-sized firms with ongoing investment projects).

36. See Rajan & Zingales, *supra* note 3, at 7 (“[W]hen 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.”).

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TABLE 1
Main Listing Requirement of Brazil's Premium Corporate Governance
Segments (as of July 2010)

	Novo Mercado	Level 2	Level 1
Securities listed	Common stock	Common stock Nonvoting preferred stock (with special voting rights in case of merger, spin-off, and related-party contracts)	Common stock Nonvoting preferred stock
Mandatory bid rule	100% price	100% price for common stock 80% price for preferred stock	80% price for common stock*
Mandatory arbitration	Yes	Yes	No
Board of directors	Minimum of 5 directors 20% independent 2-year unified term	Minimum of 5 directors 20% independent 2-year unified term	Minimum of 3 directors*
Mandatory tender offer at "economic value" in case of delisting	Yes	Yes	No
Financial statements in accordance with U.S. GAAP or IFRS	Yes	Yes	No
Minimum free float of 25% of total equity	Yes	Yes	Yes
Disclosure of material related-party contracts	Yes	Yes	Yes
Disclosure of monthly equity ownership and trading by controlling shareholders, directors, and officers	Yes	Yes	Yes
Public offerings to use mechanisms favoring capital dispersion	Yes	Yes	Yes

Note: * Mandatory requirement under Brazilian law

The less restrictive of the new segments—named Level 1 and Level 2—were given requirements reasonably acceptable to existing companies. For example, they do not restrict the issuance of preferred nonvoting 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 none of the meaningful concessions requisite for a Novo Mercado listing.

The highest level, the Novo Mercado, imposed a bundle of stricter corporate governance standards aimed at regaining investor confidence in Brazil's capital markets. The creators of the Novo Mercado saw the added value of this bundle of rights as greater than the sum of its parts—a view which is now widely shared among investors. The Exchange marketed the segment as a brand for superior corporate governance and did not permit firms to opt out of any of its listing requirements. It also correctly perceived that the overall reputational integrity of the segment was critical to its success.³⁷

The central feature of the Novo Mercado was a “one share, one vote” requirement.³⁸ This structure allowed issuers who listed on this segment to credibly commit to forgo the myriad of expropriation opportunities that controlling shareholders have historically used to exploit nonvoting preferred shareholders in Brazil. Prior to the Novo Mercado, 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 nonvoting stock and, to a lesser extent, pyramidal structures, controlling shareholders in Brazil often had a significant majority of a company's voting rights, but typically a minority of its cash flow rights.³⁹ Indeed, Brazil had both the world's largest number of dual-class firms,⁴⁰ and the largest average gap between cash flow and voting rights.⁴¹ In economic terms, this ownership pattern produced two classic types of corporate agency problems—those resulting from the absence of any external check on the control-

37. For a discussion of the role of network effects in the implementation of regulatory dualism through private organizations, see Part IV.B.2.

38. We use the term “one share, one vote” loosely to describe the absence of nonvoting shares. Voting caps and pyramidal structures were not prohibited under initial Novo Mercado regulations. See BM&F BOVESPA, REGULAMENTO DE LISTAGEM DO NOVO MERCADO [NOVO MERCADO LISTING RULES] § 3.1 (2008), available at <http://www.bmfbovespa.com.br/Pdf/RegulamentoNMercado.pdf>.

39. See, e.g., André Carvalho-da-Silva & Ricardo Leal, *Corporate Governance, Market Valuation and Dividend Policy in Brazil*, 1 FRONTIERS FIN. & ECON. 1, 6 (2004) (finding that, as of 2000, the largest shareholder in a sample of 225 Brazilian firms held, on average, 72% of the company's voting capital and 51% of its total capital); Ricardo P.C. Leal & André L. Carvalho-da-Silva, *Corporate Governance and Value in Brazil (and in Chile)* 5, 20-22 (Mar. 29, 2005) (unpublished manuscript), 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).

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

41. Tatiana Nenova, *Control Values and Changes in Corporate Law in Brazil* 2 (Sept. 25, 2001) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=294064.

ling shareholders' performance in managing the firm, and those resulting from controlling shareholders' incentives to engage in theft and tunneling.

The Novo Mercado's prohibition of nonvoting 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 for 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. This meant that, apart from other listing requirements and enforcement measures, the very capital structure of Novo Mercado firms helped deter tunneling and self-dealing, thus contributing to the segment's reputation for superior investor protection.

The Novo Mercado also imposes a mandatory bid rule under which the purchaser of a controlling block of stock must offer to purchase the rest of the company's stock at the same price per share. To be sure, the efficiency of mandatory bid requirements remains debatable.⁴² In a regime that provides insufficient shareholder protection against abuses in freezeout mergers and going-private transactions, a mandatory bid rule protects minority shareholders by allowing them to exit at a fair price upon a change of control. Mandatory bid requirements thus operate as a structural protection device that reduces the capitalized value of private benefits, albeit at the cost of preventing some efficient control transfers.⁴³ Another potential benefit of the Novo Mercado's requirement of a mandatory bid rule is that, similar to the "one share, one vote" requirement, it operates as a structural screening device for the corporate governance quality of firms choosing to take part in the segment. By preventing controlling shareholders from receiving the capitalized value of their private benefits of control upon a subsequent control sale, the mandatory bid rule serves to discourage entrepreneurs who expect to extract high private benefits from pursuing a Novo Mercado listing.

42. For a discussion of the economic properties of a mandatory bid rule, see Clas Bergström et al., *The Optimality of the Mandatory Bid Rule*, 13 J.L. ECON. & ORG. 433, 447-48 (1997) (noting the mandatory bid rule makes control transactions more expensive by imposing greater interest expenses and risk); 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); and Marcel Kahan, *Sales of Corporate Control*, 9 J.L. ECON. & ORG. 368, 378 (1993) (arguing that equal sharing rules may be less efficient than private control transfers for sales of high fractions of corporate shares).

43. 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. For a description of different modalities of extraction of private benefits of control in operating decisions, control sales, and freezeouts, see Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 787 (2003).

The listing rules also constrain the ability of controlling shareholders and managers of Novo Mercado 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 Novo Mercado must first launch a tender offer for the firm's shares at a price at least equal to their economic value.⁴⁴ The tender offer requirements also apply to delisting decisions by the Exchange for violations of listing rules.⁴⁵ These restrictions on exit from the segment are critical in ensuring the credibility of the listed firms' commitment to superior investor protection. In addition, the Novo Mercado regulations permit the São Paulo Stock Exchange to impose fines and suspend stock trading in case of noncompliance with the segment's standards.⁴⁶

The Level 2 requirements track those of the Novo Mercado except that nonvoting shares are permitted and mandatory bid requirements are limited compared to the Novo Mercado standards. Level 1 is the most lenient of the new listing standards, imposing 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 *Comissão de Valores Mobiliários* (CVM)—the Brazilian Securities and Exchange Commission—are transforming most of the Novo Mercado disclosure requirements into law, labeling Level 1 as a premium corporate governance standard is fast becoming a misnomer.⁴⁷ As described in Part IV.B, the requirements of all special listing standards are currently undergoing a revision process aimed at strengthening their corporate governance requirements.

C. Enforcing the Novo Mercado Standards

A problem with regulatory dualism—at least when deployed within a single country, as in Brazil, rather than across multiple states, as in the EU and U.S. 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 whether two regulatory regimes can be made significantly different if they both depend on the same enforcement regime.

In Brazil, the Novo Mercado and Level 2 attempt to avoid the enforcement difficulties associated with an ineffective judiciary through the provision of

44. BM&F BOVESPA, *supra* note 38, § 11.2.

45. *See id.* § 12.5.1(iii).

46. *See id.* §§ 12.2-.4.

47. The CVM was established by the Capital Markets Law, Lei No. 6.385, de 7 de Dezembro de 1976, D.O.U. de 9.12.1976, the same year of the enactment of the then-new Corporations Law. It was not until the last decade, however, that the CVM began taking a truly activist stance toward investor protection. *See infra* notes 206-08 and accompanying text.

mandatory and institutionalized arbitration for internal affairs disputes.⁴⁸ Here, as elsewhere, the conventional drawbacks of arbitration compared to public judicial procedures with respect to corporate law and complex commercial disputes apply.⁴⁹ In developing countries like Brazil, however, with weak public commercial courts, arbitration may be the only domestic means of addressing the enforcement problem. 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.⁵⁰

The Novo Mercado's approach to arbitration is designed to mitigate some of arbitration's weaknesses while maintaining its strengths. The arbitration proceedings are managed by a permanent Market Arbitration Panel established under the auspices of the São Paulo Stock Exchange,⁵¹ 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 names of the respective arbitrators, although the names and other identifying information about the parties and their lawyers are expressly exempt from disclosure requirements,⁵² which somewhat compromises the system's transparency. The Panel regulations also provide that arbitrators may take the Panel's precedents into account in their decisionmaking process.⁵³ Moreover, because the arbitration procedure is administered by the Exchange—an institution having a stake in the integrity

48. According to a 2010 cross-country comparison by the World Bank, Brazil ranks 98th out of 183 economies with respect to the ease of enforcing commercial contracts. THE WORLD BANK, DOING BUSINESS 2011: BRAZIL 64 (2010), available at <http://doingbusiness.org/~media/fpdkm/doing%20business/documents/profiles/country/db11/bra.pdf>.

49. 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, while public courts can perform better in holding parties to their incentives for performance ex ante. For a discussion of the advantages of public courts over arbitration, see Jens Dammann & Henry Hansmann, *Globalizing Commercial Litigation*, 94 CORNELL L. REV. 1, 31-39 (2008).

50. 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.

51. The involvement of the São Paulo Stock Exchange in the Novo Mercado arbitration process is not trivial. The board of directors of the São Paulo Stock Exchange 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 BOVESPA, CÂMARA DE ARBITRAGEM DO MERCADO: REGULAMENTO [MARKET ARBITRATION PANEL: REGULATION] §§ 7.8, 9.2.1 (2002), available at <http://www.camaradomercado.com.br/InstDownload/regulamentonv07012002.pdf>.

52. See *id.* § 9.13.

53. See *id.*

of the Novo Mercado—the potential for arbitral decisions to disregard policy considerations and their ex ante impact on other actors' incentives is 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.⁵⁴

The effectiveness of the Market Arbitration Panel remains untested, since 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 Novo Mercado firms; the mere availability of arbitral tribunals may serve as a check on extreme forms of opportunistic transactions by controlling shareholders and managers. However, the Brazilian judiciary also experienced a similar dearth of complaints concerning corporate governance matters for many years, which did not indicate exemplary behavior by Brazilian companies with respect to minority protection.⁵⁵ Minority shareholders may simply have recognized a lost cause when they saw one, or resorted instead to an increasingly investor-friendly CVM to file complaints.⁵⁶

All in all, the Novo Mercado 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 Novo Mercado's enforcement mechanism is effective will depend on the Novo Mercado's actual operation, to which we now turn.

D. *Experience with the Novo Mercado*

The Novo Mercado 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 Novo Mercado 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 Novo Mercado 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 became substantial, which resulted in the Novo Mercado 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

54. *Id.* § 7.12.7.

55. See Paulo Cezar Aragão, *A CVM em Juízo: Limites e Possibilidades* [*The CVM Before the Courts: Limits and Possibilities*], 34 *REVISTA DE DIREITO BANCÁRIO E DO MERCADO DE CAPITAIS* 38, 40 (2006) (noting that in the more than thirty years of authority of the 1940 Corporations Law, there was only one judicial lawsuit on the duties and liabilities of managers of Brazilian corporations).

56. See *infra* notes 206-08 and accompanying text.

less demanding and did not directly constrain existing controlling shareholders. As early as 2001, fifteen 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.

FIGURE 1
Aggregate Firms Listed by Premium Exchange Segment (2001-2009)⁵⁷

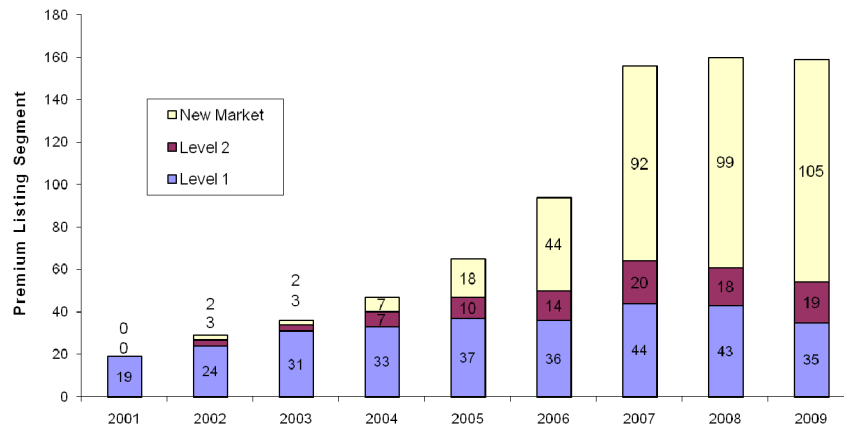
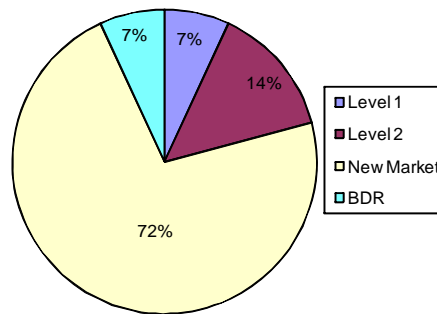


FIGURE 2
IPOs per Segment (2004-2009)⁵⁸



57. BM&F BOVESPA, GOVERNANÇA CORPORATIVA E O DESENVOLVIMENTO DO MERCADO DE CAPITAIS BRASILEIRO [CORPORATE GOVERNANCE AND THE DEVELOPMENT OF BRAZILIAN CAPITAL MARKETS] 7 (2009), http://www.valoronline.com.br/sites/default/files/bmfbovespa_0.pdf.

58. *Id.*

As anticipated by its founders, a significant majority of Novo Mercado listings took place in connection with IPOs—that is, at the point when the incentives of controlling shareholders to make corporate governance concessions are at their maximum in order to reduce their cost of capital. Over 72% of all Brazilian IPOs were listed on the Novo Mercado, and all new Brazilian listings since 2004 took place on one of the premium listing segments.⁵⁹ Indeed, the National Association of Investment Banks used its self-regulatory authority to prevent its members from underwriting new offers that did not, at a minimum, satisfy a Level 1 listing.⁶⁰ Of these, the overwhelming majority of new registrants opted for the Novo Mercado.⁶¹

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 Novo Mercado. Out of more than one hundred firms that listed on the Novo Mercado between 2002 and 2009, only approximately 20% had previously been listed on the traditional segment. This is so even though the CVM has permitted Pareto-superior reorganizations that eliminate the nonvoting shares, with the efficiency gains shared between controlling and noncontrolling shareholders. In effect, these reorganizations compensate the controlling shareholders for giving up rights to expropriate the noncontrolling shareholders.⁶² 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 Novo Mercado, so long as the minority shareholders separately approve the transaction.⁶³ Indeed, at least

59. See *Estatísticas das Aberturas de Capital na BM&FBOVESPA* [Statistics on IPOs on BM&FBOVESPA], BM&F BOVESPA, <http://www.bmfbovespa.com.br/cias-listadas/consultas/ipos-recentes/ipos-recentes.aspx?Idioma=pt-br> (last visited Feb. 20, 2011).

60. ANBID, CÓDIGO DE AUTO-REGULAÇÃO DA ANBID PARA AS OFERTAS PÚBLICAS DE DISTRIBUIÇÃO E AQUISIÇÃO DE VALORES MOBILIÁRIOS [ANBID SELF-REGULATORY CODE FOR PUBLIC OFFERINGS FOR THE DISTRIBUTION OR ACQUISITION OF SECURITIES] art. 6 (2006), available at http://www.anbid.com.br/auto_regulacao_downloads/mercado_capitais/novo_codigo_mc.pdf.

61. Many of the recent IPOs that took place outside of the Novo Mercado 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 2 listing. See 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, 455 (2009).

62. These reorganizations are examples of the “efficient restructurings” discussed in Henry Hansmann & Reinier Kraakman, Essay, *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 in Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 *STAN. L. REV.* 127 (1999).

63. Parecer de Orientação CVM [CVM Advisory Opinion] No. 34 (2006), available at <http://www.cvm.gov.br/asp/cvmwww/atos/exiato.asp?File=/pare/pare034.htm>. In a highly publicized transaction involving a major Brazilian telecom, minority shareholders rejected a

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 additional efficient migrations.⁶⁴

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 Novo Mercado, 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. The obvious explanation is that they lack sufficient 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.

Table 2 shows that, despite their limited contribution to market liquidity and trading volume, firms listed on the basic segment still represent a majority of the formally publicly traded companies in Brazil—hence their clout in opposing comprehensive legal reform and the importance of the fact that they were allowed to remain subject to the preexisting standards. 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.

proposal to migrate from the traditional segment to the Novo Mercado at conversion ratios by which common shares held by controlling shareholders would be worth three times more than preferred shares. See Simone Azevedo, *O preço da escalada* [*The Price of the Upswing*], 37 REVISTA CAPITAL ABERTO 10 (2006) (describing the structure of the proposed share exchange); *Oi! Brazil’s Shareholding Elite Receives a Black Eye from the Regulator*, ECONOMIST, Aug. 26, 2006, at 63.

64. These figures are based on the authors’ calculations from media reports on migrations and conversion prices through 2008. In addition, at least a handful of the firms that migrated to the Novo Mercado from the traditional segment had as a shareholder the investment arm of Brazil’s National Development Bank (BNDES), an early and vocal supporter of the Novo Mercado—implying that the new segment may have been embraced in these cases owing to factors other than the invisible hand of the market. Still, the potential role of BNDES alone is insufficient to explain the success of the Novo Mercado, both because migrations from the basic segment represent only a small fraction of Novo Mercado listings and because most of the Bank’s largest borrowers are not listed on the segment. See Alexandre Di Miceli da Silveira, *The Role of the BNDES (Brazilian Development Bank) on the Corporate Governance of Large Companies in Brazil* 5-6 (2010) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1639097 (showing that only five of the Bank’s top thirty borrowers in 2009 were listed on the Novo Mercado, and arguing against the view that the BNDES promotes higher corporate governance standards in investee companies).

TABLE 2
Number of Listed Firms per Segment (January 2010)⁶⁵

Segment	# Firms	% Firms	% Market Cap	% Trading Volume
Novo Mercado	106	24.5%	23.7%	33.9%
Level 2	19	4.4%	6.5%	5.1%
Level 1	35	8.1%	35.0%	36.4%
Basic and BDRs	273	63.0%	34.8%	24.6%
Total	433	100%	100%	100%

The Novo Mercado 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. Novo Mercado firms therefore have a significantly higher degree of dispersion of voting shares than those listed in other segments.⁶⁶ Moreover, the Novo Mercado 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.⁶⁷

In addition, many Novo Mercado firms are party to shareholder agreements among major blockholders,⁶⁸ which have enabled some firms to maintain an intermediate level of shareholder distribution between a single controlling shareholder on the one hand, and widely dispersed ownership on the other. Multiparty shareholder 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. 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 is constrained by collective action problems and by the difficulty of agreeing upon and contracting over expropriation methods and levels. Shared control arrangements therefore have some promise as a precommitment mechanism to avoid the extraction of private benefits of control in countries with insufficient legal protection against affiliate transactions, as is the case in Brazil.⁶⁹

65. See *Boletim Empresas* [Companies' Bulletin], BM&F BOVESPA, http://www.bmfbovespa.com.br/empresas/boletim_empresas_janeiro10.asp (last visited Jan. 31, 2011).

66. See Gorga, *supra* note 61, at 447 (noting that on the Novo Mercado, firms' largest shareholders on average own 36% of the shares, but for Level 1 and Level 2, firms' largest shareholders average 65% and 63%, respectively).

67. See *id.* at 446.

68. See *id.* at 474.

69. 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. 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

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 Novo Mercado.⁷⁰ First, dispersed ownership is often too loosely defined. Brazilian commentators and Novo Mercado regulators define “dispersed control” as the absence of any individual shareholder or group holding at least 50% of the company’s voting stock.⁷¹ 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.⁷² Moreover, the vast majority of Novo Mercado firms have adopted in their bylaws enhanced mandatory bid rules triggered at a lower threshold and imposing a higher premium than the Novo Mercado standards.⁷³ These enhanced mandatory bid rules, as well as shareholder agreements, allow small groups of major shareholders to exercise uncontested control even though no single shareholder holds a majority of voting shares.

write legal contracts to that effect. See 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).

70. 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 Novo Mercado companies—though this is not the case if one counts only voting shares. See Gorga, *supra* note 61, at 523-24.

71. BM&F BOVESPA, *supra* note 38, § 2.1 (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 61, at 480 n.133 (adopting a 50% ownership threshold to identify the presence of a controlling shareholder).

72. For example, the law and finance literature adopts a substantially lower threshold to ascertain the existence of a controlling shareholder. See, e.g., Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 491-98 (1999) (using 20% and 10% thresholds to determine control).

73. The vast majority of firms going public in recent years adopted in their bylaws some form of enhanced mandatory bid rule, which is subject to triggers generally ranging from 10% to 35% of the company’s shares. See Lucia Rebouças & Nelson Rocco, *Conceitos Básicos de Governança Se Tornam Consensos de Mercado [Basic Corporate Governance Concepts Become Consensus in the Market]*, GAZETA MERCANTIL, May 19, 2008, available at 2008 WLNR 9428814. These mandatory bid rule requirements typically impose a minimum premium requirement—which, in the case of some companies, reaches the exorbitant amount of 50% above the firm’s fifty-two-week high price, thus effectively serving as a takeover shield. See S. Wade Angus & Mariana Pargendler, *Opportunities and Challenges for Foreign Private Equity Investors in Brazil*, in INTERNATIONAL BUSINESS TRANSACTIONS WITH BRAZIL 63, 73 (Beatriz Franco et al. eds., 2008). Moreover, many such clauses were drafted as 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. See Gorga, *supra* note 61, at 483. Despite their popularity, the CVM has recently asserted that these “immutable” provisions in firm bylaws are invalid under Brazilian law. See Parecer de Orientação CVM [CVM Advisory Opinion] No. 36 (2009), available at <http://www.cvm.gov.br/asp/cvmwww/atos/Atos/pare/pare036.doc>.

Although the Novo Mercado is by no means the only factor that contributed to the capital market boom in Brazil in recent years,⁷⁴ the expansion of Brazilian capital markets following the Novo Mercado's launch was remarkable. In 2007, Brazil was the third-most active IPO market in the world, after China and the United States, and was responsible for 10% of the volume of such offerings worldwide.⁷⁵ By mid-2008, Brazil's stock market capitalization for the first time equaled its GDP,⁷⁶ and the Novo Mercado alone had one hundred listings. Figure 3 shows that the index of firms listed on the premium corporate governance segments (Level 1, Level 2, and Novo Mercado) (IGC) has consistently outperformed both the index composed of the fifty most traded stocks (IBRX 50) and the index representing 80% of the exchange's trading volume (Ibovespa).⁷⁷

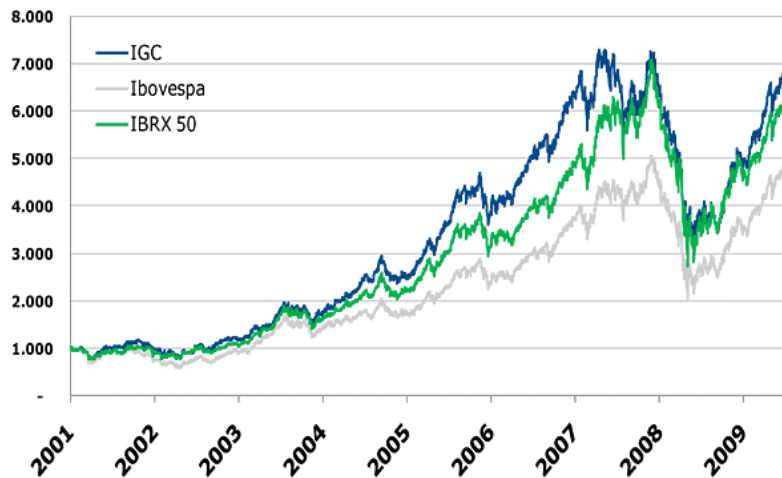
74. Improvements in domestic macroeconomic conditions, including the decline in interest rates of Brazilian public bonds and booming international financial markets, were also key to the renaissance in Brazil's capital markets starting in 2004. Previously, the combination of high inflation, staggering 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 73, at 73.

75. ERNST & YOUNG, GROWTH DURING ECONOMIC UNCERTAINTY: GLOBAL IPO TRENDS REPORT 2008, at 2 (2008). In 2007 Brazil raised \$27.3 billion in IPOs, compared to \$34.2 billion in the United States and \$66 billion in China. *Id.*

76. Fabricio Vieira, *Valor das empresas na Bolsa alcança o PIB* [Value of Firms in the Exchanges Equals GDP], FOLHA DE SÃO PAULO, June 16, 2008, <http://www1.folha.uol.com.br/folha/dinheiro/ult91u412753.shtml>. In 1996, Brazil's stock market capitalization equaled 27% of GDP, and in 2000, 37% of GDP. *Id.*

77. There is also empirical support for the link between better corporate governance and better corporate performance in Brazil. Based on a large-sample 2004 survey of publicly traded Brazilian firms, Bernard Black, Antonio Gledson de Carvalho, and Érica Gorga find a positive statistically significant relation between quality of governance and corporate performance as measured by Tobin's *q*. Bernard Black et al., *Does One Size Fit All in Corporate Governance? Evidence from Brazil (and Other BRIC Countries)* 5 (Univ. of Tex. Law Sch. Law & Econ. Research Paper, Paper No. 152, 2009), available at <http://ssrn.com/abstract=1434116>.

FIGURE 3
Evolution of Stock Indices at the São Paulo Stock Exchange⁷⁸



Just like its counterparts around the world, Brazil's capital markets suffered 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 (see Figure 3).⁷⁹ The São Paulo Stock Exchange was home to the largest IPO worldwide in 2009, which, at approximately \$8 billion, was the largest in its history.⁸⁰ The Novo Mercado'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.⁸¹

78. See *Boletim Empresas*, *supra* note 65.

79. Recent empirical work suggests that, due in part to better corporate governance standards, the stock prices of companies listed on the São Paulo Exchange premium listing segments (Level 1, Level 2, and the Novo Mercado) were less sensitive to changes in the market and had lower volatility than the stock prices of companies listed on the traditional segment. See Pablo Rogers & José Roberto Securato, *Corporate Governance and Volatility in the Capital Markets: Brazil Case Study*, 7 J. CORP. OWNERSHIP & CONTROL 40 (2009). These findings, however, precede the 2008 financial crisis, a time when the share prices of firms listed on the Novo Mercado fell more than those of companies listed on the traditional segment. The stock prices of Novo Mercado firms have since largely recovered.

80. Lynn Cowan & Rogerio Jelmayer, *Year's Biggest IPOs Make Debuts*, WALL ST. J., Oct. 8, 2009, at C3. Banco Santander S.A. opted for a Level 2 listing, as did other banks going public in recent years.

81. Danilo Gregório & Simone Azevedo, *Inspiration for the East: Encouraged by the Novo Mercado's Success, the Philippines and India Create Special Listing Tiers in Their Own Stock Exchanges*, REVISTA CAPITAL ABERTO, Aug. 2009, at 38.

II. OTHER EXAMPLES OF REGULATORY DUALISM IN CORPORATE LAW

Brazil's Novo Mercado 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 defuse political opposition from existing elites. Because the Olson problem is pervasive, and in no way limited to developing countries,⁸² regulatory dualism has broad application as a means of facilitating economic growth. Nor is regulatory dualism a wholly recent legal development.⁸³ The medieval law merchant, a transnational body of commercial law—distinct from the general law of the era, and with its own separate courts—arose among merchants across Europe, was arguably an example of regulatory dualism.⁸⁴

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 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,⁸⁵ after World War II its economy became largely dependent on bank financing. From 1965 to 1996, only 434 companies went public on the Frankfurt Deutsche Börse, Germany's principal stock exchange.⁸⁶ Germany's publicly

82. See OLSON, *supra* note 3, at 3, 77-79 (citing Britain after World War II as the most notable case of relative decline owing to the harmful influence of powerful interest groups).

83. See, e.g., TULLIO ASCARELLI, PANORAMA DO DIREITO COMERCIAL [PANORAMA OF COMMERCIAL LAW] 13 (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).

84. See, e.g., *id.* at 46-49 (noting that the economic demands relating to the dynamism of the emerging commerce required a departure from the civil law principles, which continued to govern agrarian relations); A. CLAIRE CUTLER, PRIVATE POWER AND GLOBAL AUTHORITY 109 (2003) ("[T]he 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 11 (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). *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).

85. See Eric Nowak, *Investor Protection and Capital Market Regulation in Germany,* in THE GERMAN FINANCIAL SYSTEM 425, 426 (Jan Pieter Krahen & Reinhard H. Schmidt eds., 2004) (noting that prior to World War I, Germany's stock markets boasted nearly twelve hundred listed companies compared to the approximately six hundred firms listed on the New York Stock Exchange).

86. MB ASSOCIADOS, *supra* note 10, at 42 (citing Simon Johnson, *Which Rules Matter? Evidence from Germany's Neuer Markt* (2000) (unpublished manuscript)).

traded corporations were mostly large, mature firms, displaying an average of fifty-five years of existence by the time of their IPO.⁸⁷

While the bank-centered corporate finance regime served Germany well in the immediate postwar 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.⁸⁸ In 1987, the Frankfurt Deutsche Börse 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.⁸⁹ The Regulated Market, however, failed to attract a significant number of listings and afford sufficient liquidity.⁹⁰

Ten years later, to halt the flight of new German listings to the NASDAQ, the Frankfurt Deutsche Börse 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.⁹¹ The need to find financing alternatives for start-ups was especially acute in Germany, since banks had come under increasing criticism for their unwillingness to finance high-tech firms.⁹² 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 Novo Mercado, the Neuer Markt was more, not less, regulated than Germany’s official segment, whose requirements were left untouched by this new initiative.⁹³ As La Porta et al. have recognized, the Olson problem was a

87. John Schmid, *Menu Is Meager at ‘New’ Exchanges*, INT’L HERALD TRIB. (Paris), Mar. 12, 2003, at 11.

88. 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 2* (Oct. 2003) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=497404.

89. *See id.* at 3.

90. *See id.*

91. 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 1996. *See* Gail Edmondson & Heidi Dawley, *Europe as High-Tech Heaven?*, BUSINESSWEEK, May 12, 1997, at 20. 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.” DEUTSCHE BÖRSE GRP., RULES AND REGULATIONS NEUER MARKT, at pt. 1, §1 (1999), available at <http://www.cnmv.es/delfos/tendencias/neuer.pdf>.

92. *See* 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).

93. *See, e.g.*, Erik Theissen, *Organized Equity Markets*, in THE GERMAN FINANCIAL SYSTEM, *supra* note 85, at 139, 144.

driving force behind Germany's creation of the Neuer Markt, as established and bank-dominated German firms were generally hostile to changes in their legal regime.⁹⁴ In short, the Neuer Markt was a clear example of regulatory dualism.

Neuer Markt firms were required to sell only common, rather than nonvoting preferred shares;⁹⁵ ensure a 25% minimum free-float;⁹⁶ report earnings quarterly in English and German, in accordance with International Accounting Standards (IAS) or U.S. Generally Accepted Accounting Principles (GAAP);⁹⁷ provide for a lockup prohibiting sales by the original shareholders for six months after the initial offering;⁹⁸ obtain two sponsors responsible for the liquidity and tradability of the shares;⁹⁹ and raise at least 50% of the issuer's value in new equity.¹⁰⁰ 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.¹⁰¹ 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."¹⁰² An arbitration panel was organized by the Deutsche Börse to decide disputes about Neuer Markt admission and enforcement decisions.¹⁰³

Notwithstanding the initial skepticism about an overly regulatory approach,¹⁰⁴ the Neuer Markt was quite successful in its first years. At its peak in early 2000 it had more than three hundred listings and a market capitalization exceeding \$400 billion.¹⁰⁵ Moreover, the Neuer Markt's focus on individual investors helped to more than double the equity ownership of German adults

94. See La Porta et al., *Investor Protection and Corporate Governance*, *supra* note 2, at 22 ("[C]aptains of German industry have accepted [the Neuer Markt] because their firms were not directly affected.").

95. See DEUTSCHE BÖRSE GRP., *supra* note 91, pt. 2, § 3.4.

96. *Id.* § 3.10.

97. *Id.* § 4.1.9.

98. *Id.* § 2.2.

99. *Id.*

100. *Id.* § 3.8.

101. *Id.* §§ 3.1(2), 3.2.

102. *Id.* § 2.1(2). The listing committee rejected about 20% of the applicants based on a "subjective" approach. See Stewart Fleming, *The Neuer Markt's Wild Ride*, INSTITUTIONAL INVESTOR, Apr. 1999, at 42.

103. DEUTSCHE BÖRSE GRP., *supra* note 91, pt. 5, § 2.

104. See, e.g., Sharon Reier, *On the Continent, a Hodgepodge of Local Standards and Laws; Full Disclosure: Where (Outside the U.S.) to Find Company Data*, INT'L HERALD TRIB. (Paris), Nov. 6, 1999, at 15 (citing early remarks by market participants that the Neuer Markt would "die in beauty" as the rigorous standards would discourage listings).

105. Mark Landler, *German Technology Stock Market to Be Dissolved*, N.Y. TIMES, Sept. 27, 2002, at W1.

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over a three-year period.¹⁰⁶ The media credited the Neuer Markt for overriding Germany's legendary lack of an "equity culture."¹⁰⁷

The Neuer Markt became the envy of its European competitors, giving rise to the rapid adoption of regulatory dualism in other countries.¹⁰⁸ High-growth listing segments in Amsterdam, Brussels, Paris, and Milan emulated at least some of the Neuer Markt's requirements.¹⁰⁹ A few years later, Europe would have some thirty special listing segments for small-cap companies.¹¹⁰ In addition, the Frankfurt Deutsche Börse 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.¹¹¹

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.¹¹² In the three years after its launch, the Neuer Markt index rose nearly tenfold, which helped lure additional investors.¹¹³

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.¹¹⁴ 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 tenfold rise, was left on the brink of bankruptcy after a self-dealing scandal involving an investment vehicle owned by its founder's wife.¹¹⁵ Comroad, a traffic-navigation

106. See Vanessa Fuhrmans, *Playing by the Rules: How Neuer Markt Gets Respect*, WALL ST. J., Aug. 21, 2000, at C1. The percentage of German adults holding shares soared from approximately 9% in 1997 to 20% in 2000. Landler, *supra* note 105.

107. *Neuer Markt's Global Ambitions*, MARKETWATCH (June 23, 1999), <http://www.marketwatch.com/story/neuer-markts-global-ambitions>.

108. See Renault Enguerand, *La guerre des nouveaux marchés d'actions fait rage en Europe; Le Neuer Markt allemand est en position de force* [*The War of New Equity Markets Rages Europe; The German Neuer Markt Is in a Strong Position*], LE MONDE, Feb. 10, 1999.

109. Fuhrmans, *supra* note 106.

110. Schmid, *supra* note 87.

111. See Fuhrmans, *supra* note 106. Little more than one year after its launch, the SMAX featured 125 listings. *Id.*

112. See Burghof & Hunger, *supra* note 88, at 8.

113. Brian M. Carney, *Teutonic Tailspin: A German Market's Rise and Fall*, WALL ST. J., Oct. 1, 2002, at A20.

114. Danny Fortson, *View from the City: AIM Carefully*, DAILY DEAL, Apr. 18, 2005, available at 2005 WLNR 5939689.

115. Carney, *supra* note 113.

technology firm, turned out to have fabricated nearly all of its reported revenue for 2001.¹¹⁶ Internet advertiser Adpepper reduced its earnings expectations less than one month after its IPO.¹¹⁷ The required sponsors for Infomatec, a software company, quit after the firm made overly rosy statements about its pending contracts.¹¹⁸ The founder of EM.TV, a media company, breached the mandatory lockup requirement and sold nearly two hundred thousand shares within six months of the initial offering.¹¹⁹ Moreover, a regulatory loophole allowing company founders to sell their shares after the initial six-month lockup period without market disclosure consistently distorted trading in less liquid Neuer Markt firms.¹²⁰

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.¹²¹ It was not until 2001 that the Deutsche Börse raised its maximum fine for individual violations tenfold to €100,000, which was still a modest amount for most companies.¹²²

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.¹²³ 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.¹²⁴

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 under-

116. *Id.*

117. Edmund L. Andrews, *Think Nasdaq. Now Double the Pain.*, N.Y. TIMES, Jan. 28, 2001, § 3, at 1.

118. 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, at 58.

119. Andrews, *supra* note 117.

120. *See id.*

121. Fuhrmans, *supra* note 106.

122. *See* DEUTSCHE BÖRSE GRP., *supra* note 91, pt. 2, § 2.1(4); Jack Ewing, *The Neuer Markt Needs a Watchdog with Teeth*, BUSINESSWEEK, Jan. 8, 2001, at 25.

123. *See* Fuhrmans, *supra* note 106.

124. *See* Josef Tobien & Olaf Schick, *New Listing Regulations: Neuer Markt*, in THE IFLR GUIDE TO GERMANY 27 (2001); Memorandum, Dewey Ballantine LLP, End of Neuer Markt 3-4 (Oct. 15, 2002) (on file with authors).

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mined the credibility of the entire pool.¹²⁵ 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.¹²⁶ The Neuer Markt, once a quality seal, became a "synonym for failure."¹²⁷ After significant brand damage, the Deutsche Börse discontinued the Neuer Markt altogether in 2003.

What lessons are there to be learned from the rise and fall of Frankfurt's Neuer Markt? First, the Neuer Markt exposed some of the pitfalls of regulatory dualism when implemented by private regulatory organizations. The willingness of stock exchanges to effectively enforce listings requirements, and their ability to update these standards in light of changing circumstances, clearly matter. Moreover, the Neuer Markt's narrow industry focus on high-tech companies turned out to be a major liability when macroeconomic conditions changed, thus suggesting that a more diversified new-market strategy is more likely to survive over time. We address each of these issues in greater detail in Part V below. Second, timing and luck are critical; were it not for a major bubble burst in its early years, the Neuer Markt might well have survived. Finally, failure might not mean total failure. The Neuer Markt ultimately collapsed, but in the interim it induced a significant rise in stock ownership among German households, thus increasing the number of constituencies pushing for greater investor protection. The Neuer Markt's disclosure standards, once exceptional, are now mandatory for all listed firms in Germany.

B. *The EU Choice of Corporate Law Regime: Centros and the Societas Europaea*

Two recent changes in the EU choice of corporate law regime operate as a form of regulatory dualism by creating a more efficient choice for small growth-oriented companies while protecting the positions of the established economic and political elite by retaining existing regulation critical to those positions. Unlike the private actions of stock exchanges with respect to the Novo Mercado and Neuer Markt, in both EU cases the dual regulatory regimes were imposed by government—in one case by the European Court of Justice through its *Centros* decision, and in the other by the European Union's adoption of a regulation and directive allowing the formation of a corporation under Euro-

125. See Rachel Stevenson, *Scandals and Bankruptcies Destroy Germany's Neuer Markt*, INDEPENDENT (London), Sept. 27, 2002, at 23 (quoting 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 33, 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").

126. See Neal E. Boudette & Alfred Kueppers, *Neuer Markt Faces Mounting Pressure from Members to Tighten Listing Rules*, WALL ST. J., July 11, 2001, at C12.

127. Landler, *supra* note 105.

pean—as opposed to member-state, law. In both cases, however, the changes were adopted at the EU level but had their impact in dissipating the Olson problem at the level of the member state.

1. *Centros and choice of state of incorporation*

Following the European Court of Justice's decision in *Centros*,¹²⁸ the European Union's approach to corporate law regulation effectively embodies a dual regulatory strategy. To see this, assume that elements of German corporate governance regulation, most notably codetermination, are ill-suited to the formation and growth of new economy companies.¹²⁹

While there have been many entrenched interest groups that acted to restrain growth-oriented corporate reforms in Europe, the most conspicuous are the German workers, and particularly the German labor unions, who both have a stake in the system of codetermination currently imposed by law on all companies incorporated in Germany and the political power to block corporate law reform that would threaten codetermination.

Reforming codetermination to eliminate the barriers to the growth of new economy companies thus directly confronts the Olson problem: economic growth requires regulatory reform that is blocked by existing elites whom the reform would disadvantage.¹³⁰ In the context of codetermination, a plausible compromise might be to exclude new economy companies from the codetermination regime, 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 reform of codetermination because of the concern that any change threatens the entire regime.¹³¹

In this circumstance, a regime of regulatory dualism that could not be adopted by the *Bundestag* (lower house of the German parliament) was exter-

128. Case C-212/97, *Centros Ltd. v. Erhervs-og Selskabsstyrelsen*, 1999 E.C.R. I-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, 350-56 (2001).

129. The German codetermination system is composed of a complex set of statutes; however, for our purposes it consists of the requirement that the supervisory boards of corporations with more than five hundred employees have one-third employee representatives and those of corporations with more than two thousand employees have one-half employee representatives. See Betriebsverfassungsgesetz [BetrVG] [Industrial Constitution Act], Oct. 11, 1952, BUNDESGESETZBLATT, Teil I [BGBL. I] at 681; Mitbestimmungsgesetz [MitbestG] [Codetermination Act], Apr. 5, 1976, BGBL. I at 1153; see also Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, in EMPLOYEES AND CORPORATE GOVERNANCE 163, 165-68 (Margaret M. Blair & Mark J. Roe eds., 1999) (summarizing the German codetermination system).

130. See Pistor, *supra* note 129, at 165-68 (tracing the political history of worker involvement in corporate governance).

131. See *id.* at 165.

nally imposed (whether or not intentionally) by the ECJ 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 corporate governance system in the state of incorporation may impose fewer restrictions than the country in which the business is actually carried out; prior to *Centros*, those additional restrictions would have been applicable because of the real seat doctrine.¹³² For example, after *Centros*, a biotechnology start-up relying on German scientists for talent could incorporate in the United Kingdom, thereby avoiding the eventual application of the German codetermination regime if the start-up proves successful, while still retaining its German primary business location. At the same time, existing large German companies remain subject to codetermination because of the significant remaining barriers to shifting country of incorporation, whether through merger¹³³ or via direct transfer of state of incorporation.¹³⁴

132. See Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.*, 2003 E.C.R. I-10155; Case C-208/00, *Überseering BV v. Nordic Constr. Co. Baumanagement GmbH (NCC)*, 2002 E.C.R. I-9919; *Centros*, 1999 E.C.R. I-1459. Some question remains as to whether *Centros* actually prevents Germany from protecting codetermination. While *Centros* prevents Germany from blocking German businesses from incorporating elsewhere, some argue that Germany nonetheless could impose codetermination by legislation on such “pseudo-foreign” companies regardless of their state of incorporation. See, e.g., Jens C. Dammann, Note, *The Future of Codetermination After Centros: Will German Corporate Law Move Closer to the U.S. Model?*, 8 *FORDHAM J. CORP. & FIN. L.* 607, 613-14 (2003). Germany has not passed such legislation. Even assuming that such legislation would not conflict with the treaty, the effect of *Centros* is to shift the political burden of going forward with legislation. Before *Centros*, the business community required legislation to restrict codetermination, which the labor unions could block. After *Centros*, the labor unions require legislation to overcome *Centros*, which the business community can block.

133. 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 EU Cross-Border Merger Directive on cross-border mergers of companies with share capital, Parliament and Council Directive 2005/56, 2005 O.J. (L 310) 1 (EC), 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 M. Siems, *The European Directive on Cross-Border Mergers: An International Model*, in *CORPORATE MERGERS: MODERN APPROACHES* 156, 167-68 (P.L. Jayanthi Reddy ed., 2009).

134. A second method by which to shift a corporation’s state of incorporation is to simply transfer the state of incorporation, accomplished by dissolving the existing corporation and reincorporating it in 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.” *Commission Staff Working Paper, Impact Assessment on the Directive on the Cross-Border Transfer of Registered Office*, at 5, 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.*; see also European Parliament Resolution of 10 March 2009 with a Recommendation to the Commission on the

Thus, in practice *Centros* imposed regulatory dualism with respect to codetermination. New companies that are most likely to need access to new equity capital can opt out of codetermination by foreign incorporation and thereby avoid restrictions on efficient organizational structure.¹³⁵ At the same time, the sources and focus of labor's political power—existing large companies—remain subject to local regulation, at least until newly established firms become so large and numerous as to dominate the local political scene.¹³⁶

2. *The Societas Europaea*

An alternative approach to avoiding codetermination that is available to German new economy companies—selecting the form of a *Societas Europaea* (SE) or “European Company” formed under EU law as opposed to the corporate law of a member state—creates a dual regulatory structure similar to that established by *Centros*. The regulation and directive establishing the *Societas Europaea*¹³⁷ require that a company subject to some level of codetermination before becoming a European Company remain subject to that level of employee board participation unless employees agree to changes.¹³⁸ Thus, a German

Cross-Border Transfer of the Registered Office of a Company, 2010 O.J. (C 87) 5, 7 (recommending a transfer of registered office directive).

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

136. 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. Parliament and Council Directive 2005/56, art. 16, § 7, 2005 O.J. (L 310) 8 (EC). Since the language of the Directive refers only to “subsequent domestic mergers,” 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. *Id.* (emphasis added). Finally, simple reincorporation may be available after the European Court of Justice's decision in *Cartesio*, which constrains a member state from restricting reincorporation by treating it as a liquidation under local law. Case C-210/06, *Cartesio Oktató és Szolgáltató bt*, 2008 E.C.R. I-9641. Here the doctrinal analysis remains quite uncertain. See, e.g., Andrzej W. Wiśniewski & Adam Opalski, *Companies' Freedom of Establishment After the ECJ Cartesio Judgment*, 10 EUR. BUS. ORG. L. REV. 595, 611 (2009).

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.

137. Council Regulation 2157/2001, 2001 O.J. (L 294) 1 (EC); Council Directive 2001/86, 2001 O.J. (L 294) 22 (EC).

138. See Jochem Reichert, *Experience with the SE in Germany*, 4 UTRECHT L. REV. 22, 28 (2008).

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company that has fewer than five hundred employees when becoming a European Company is not subject to codetermination at all; the supervisory board of a company with more than five hundred but fewer than two thousand employees is required to have only one-third worker representatives. Most importantly, the German company's codetermination obligation is frozen at the time it becomes a European Company; future growth cannot alter the required level of employee board representation. A company with fewer than five hundred employees at the time of its conversion is forever free of codetermination, and a company with between five hundred and two thousand employees will be subject only to the one-third employee-director requirement regardless of further growth in its work force.¹³⁹ Large companies with more than two thousand employees, however, are locked in to the requirement that one-half of the supervisory board be employee representatives. As with *Centros*, the European Company provisions allow small companies to avoid codetermination but protect existing labor influence by retaining full codetermination for large established companies.

While different in structure than the Brazilian Novo Mercado strategy, both *Centros* and the *Societas Europaea* option have similar effects on the Olson problem: they provide a mechanism that lets the new economy develop while leaving the existing power structure—labor in the case of codetermination—protected.¹⁴⁰ And like the Novo Mercado, *Centros* and the *Societas Europaea* operate in the German context not as invitations to regulatory competition, but as instances of regulatory dualism in which new and established companies are treated differently, preserving the positions of politically powerful groups while

139. See *id.* at 28. Reichert reports that one German company converting to a European Company form disclosed to its shareholders that one motive for making the shift was to freeze its codetermination obligation at the one-third level. *Id.*; see also Horst Eidenmüller et al., *Incorporating Under European Law: The Societas Europaea as a Vehicle for Legal Arbitrage*, 10 EUR. BUS. ORG. L. REV. 1 (2009) (finding strong evidence that firms have adopted the SE form in order to avoid or mitigate the effects of mandatory codetermination laws). Efforts to test this hypothesis empirically using event study techniques have not found distinctive abnormal returns when the company shifting to a European Company previously had been subject to German codetermination. See, e.g., Horst Eidenmüller et al., *The Societas Europaea: Good News for European Firms* 20 (European Corporate Governance Inst., Working Paper No. 127/2009, 2009), available at <http://www.ssrn.com/abstract=1409555>; Felix Lamp, *Value Creation and Value Destruction in the Societas Europaea: Evidence from the New Legal Form* 22-23 (Dec. 18, 2010) (unpublished manuscript), available at <http://www.ssrn.com/abstract=1728162>. Because of the small sample size in both studies, the results are not persuasive.

140. As yet, the empirical evidence is consistent with half of the analysis: by and large, existing large firms have remained incorporated in Germany. With respect to newly formed corporations, however, the largest number of German-located businesses incorporating outside Germany are small local businesses, of the sort actually involved in *Centros*, rather than, like the example in the text, venture capital-backed technology start-ups. See Marco Becht, Colin Mayer & Hannes F. Wagner, *Where Do Firms Incorporate? Deregulation and the Cost of Entry*, 14 J. CORP. FIN. 241, 247-48 (2008) (providing empirical evidence concerning Germany-based firms incorporating in the United Kingdom).

at the same time facilitating new companies' access to more efficient organizational structures.

C. *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, in important part, as the fruit of an ongoing system 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 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 the U.S. system of state-level corporate chartering. This system combines an "internal affairs doctrine" (according to which the laws of the state of incorporation govern the relationships among managers, directors, shareholders, and creditors) with freedom of choice as to state of incorporation without regard to the location of the firm's operations. The existing literature views the system largely in terms of regulatory competition. Yet that system also has important elements of regulatory diversification, regulatory experimentation, and regulatory dualism. We focus here on the latter.

1. *General corporation chartering*

Roughly half of all publicly traded U.S. corporations are chartered in their headquarters state; nearly all the rest are incorporated in Delaware. States other than Delaware rarely attract out-of-state incorporations.¹⁴¹ This pattern seems easily understood as a long-standing system of regulatory dualism, in which each state other than Delaware offers its own established regime of corporate law, while Delaware offers, vis-à-vis each of the other states, a reformist regime. Companies whose managers or controlling shareholders wish to use local political influence to protect their personal interests, perhaps to the disadvantage of noncontrolling shareholders, have an incentive to incorporate in their headquarters state. Companies whose managers or controlling shareholders, in contrast, are more interested in establishing a high market value for their shares

141. See Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 386 (2003); 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 that incorporate outside of their home state choose Delaware).

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prefer to incorporate in Delaware, whose law offers (at least modestly) greater shareholder protection and overall efficiency than do the laws of other states.

Consider first Delaware. Nearly all companies that are incorporated in that small and thinly industrialized state have their headquarters and other activities elsewhere. Delaware famously collects substantial franchise fees from companies it charters, giving it a strong pecuniary interest in inducing out-of-state companies to incorporate under Delaware law. Because both managers and majority shareholders—and only they—have a veto in choosing a company's state of incorporation, Delaware must provide law that is at least acceptable to both groups. At the same time, Delaware is free from pressure to tailor its corporate law to suit the special interests of other corporate constituencies—such as employees, suppliers, creditors, local businesses, or local governments—because those constituencies generally have no presence, and thus no political influence, within the state.¹⁴²

In every other state in the United States, the situation is just the opposite. None of those states derives a meaningful amount of revenue from corporate chartering, nor is it likely that they could.¹⁴³ And companies incorporated in one of those states nearly always have their headquarters in that state.¹⁴⁴

Why do these other states provide corporate law at all, rather than just leaving local companies to incorporate in Delaware? The reason is evidently to serve the needs of politically influential interest groups within the state. One such group comprises the managers and controlling shareholders of small, mostly closely held companies for which the transaction costs of incorporating—and especially litigating—out of state would be a substantial burden.¹⁴⁵ A second group comprises the managers and majority shareholders of larger companies, and particularly publicly traded companies, for which incorporation in another state, including Delaware, would not in itself be particularly inconvenient. For the second group, an important advantage of incorporating locally, rather than in Delaware or any other state, is that they can use their local political influence to mold corporate law—including both statutory law and the deci-

142. See Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2500 (2005); Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 212-13 (2006).

143. See Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 688-89 (2002).

144. See Bebchuk & Cohen, *supra* note 141, at 386; Daines, *supra* note 141, at 1574.

145. See Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 374-75 (1992) (describing costs); Jens Dammann & Matthias Schündeln, *The Incorporation Choices of Privately Held Corporations*, J.L. ECON. & ORG. (forthcoming 2011) (finding that 93% of a broad sample of closely held corporations are incorporated in their home state).

sions reached in individual cases—to serve their personal interests.¹⁴⁶ Those interests today include, conspicuously, protection from takeovers.

By choosing to incorporate in their home state, a company's managers and shareholders can not only use their political influence directly, but can also leverage that influence substantially by allying themselves with other in-state actors who might suffer if the company were taken over and, as a consequence, restructured or relocated.¹⁴⁷ These other actors may include the company's present and potential employees and their unions, as well as the company's suppliers, other local merchants, and local governments.¹⁴⁸ At the same time, the noncontrolling shareholders who stand to lose from strong antitakeover barriers, and from other accommodations to the interests of managers and controlling shareholders, commonly have negligible influence on local politics in the state of incorporation.

Beyond providing leverage with the state legislature, incorporating a company in its 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, going in the other direction, incorporating locally is probably an effective signal that the company's managers or controlling shareholders consider their interests tied to the home state, and hence increases their local political influence.

In short, states other than Delaware exhibit the Olson problem, offering corporate law tailored to serve the interests of politically influential local companies, and particularly their managers and controlling shareholders.

Evidence for this interpretation is provided by the extreme rarity of companies that are incorporated in a state other than their home state or Delaware. If companies choosing to incorporate in states other than Delaware were doing so because the chosen state offered a superior body of corporate law, then those companies should often choose a third state rather than always choosing their home state.

146. See, e.g., Kahan & Kamar, *supra* note 143, at 735 (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).

147. See Roe, *supra* note 142, at 2525-26.

148. In fact, it is common to see managers and their employees or labor unions working together for protective antitakeover action from a state legislature. See Daines, *supra* note 141, at 1579-80 & n.70 (noting that “[i]n state after state, managers have successfully lobbied for statutes that restrict takeovers and protect managers (and possibly employees) at the expense of shareholders,” and citing a case in Massachusetts in which a company was able to secure favorable protective legislation because it “was a large employer and rallied its employees to spirited protest meetings”); Mark J. Roe, *Takeover Politics*, in *THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE* 321, 339-40 (Margaret M. Blair ed., 1993) (describing a successful lobbying effort by Pennsylvania corporations and labor unions to get an antitakeover statute enacted).

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It is also telling that, empirically, companies located in small states are more likely to incorporate locally than are companies located in large states.¹⁴⁹ Since large states generally have better-developed (and hence, at the very least, more predictable) corporate law than do small states, this behavior seems inconsistent with the theory that companies are simply looking for the better body of corporate law. It is, however, highly consistent with the Olsonian interpretation, since a company's individual influence on local corporate law should be inversely proportional to the size of the jurisdiction.

To be sure, the observed pattern of incorporation is also consistent with the theory that a company's state of incorporation is, to some degree, a fortuitous consequence of the company's choice of legal counsel. Companies that seek advice from local law firms are more likely to be advised to incorporate in their headquarters state, since that is the state whose law is most familiar to the local lawyers. Firms that seek advice from national law firms, in contrast, are more likely to be advised to incorporate in Delaware, whose law is more familiar to those firms. Daines presents evidence that, at least for companies undertaking an IPO, this theory has some explanatory power: companies advised by local law firms are more likely to incorporate in their home state.¹⁵⁰ But the law firm theory is not inconsistent with the Olsonian theory. In fact, the two theories overlap: a company might choose a local law firm in part because of the law firm's experience and connections with the local political system, including the local courts. Moreover, the law firm theory on its own seems inadequate to explain why companies in large states would more often choose Delaware law than do companies located in small states. There is no readily apparent reason that companies in small states would prefer local counsel more frequently than those in large states, except for the possibility that a law firm in a small state is more likely to be politically well connected.

In any event, the strongest evidence for the Olsonian theory of home state incorporation is direct. To begin with, most states have adopted more, and more restrictive, statutory antitakeover provisions than has Delaware.¹⁵¹ Although there is debate about the amount of additional protection such provisions ac-

149. See Bebchuk & Cohen, *supra* note 141, at 395 tbl.5 (showing, for all fifty states, the percentage of firms located in each state that are incorporated in that state, and revealing a negative correlation between local incorporation and state size); Daines, *supra* note 141, at 1606 tbl.A2 (revealing a similar negative correlation in thirty states and the District of Columbia between size and percentage of firms incorporated locally).

150. Daines, *supra* note 141, at 1581, 1585.

151. See Kahan & Kamar, *supra* note 143, at 740 (“[B]ecause, unlike noncompeting states, Delaware also had an interest in not antagonizing shareholders of companies that it might attract from other states . . . it passed a milder [antitakeover] statute.”). There are also abundant examples of state-level corporate law reforms that have been hindered by local interest groups. 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. *Id.* at 732. Similarly, public interest lawyers and labor unions prevented the creation of a chancery court in Pennsylvania. *Id.* at 733.

tually offer in comparison to Delaware law,¹⁵² there is good reason to conclude that the increment is meaningful—in part because the statutory provisions seem more dependable than Delaware's largely judge-made antitakeover law, which the Delaware courts have repeatedly trimmed to the prevailing winds.¹⁵³ In general, while there is good reason to believe that Delaware corporate law is more managerialist than efficiency calls for,¹⁵⁴ and perhaps more oriented to the interests of lawyers and the judiciary as well,¹⁵⁵ there is now reasonably broad agreement that it is overall more efficient, and in particular more protective of the interests of noncontrolling shareholders, than is the corporate law of most or all other states.

Moreover, if states other than Delaware have managed to adopt antitakeover legislation that is only quantitatively, rather than qualitatively, more protectionist than is Delaware's antitakeover law, it is not for want of trying. The first generation of antitakeover statutes, adopted in some form by thirty-seven states but not by Delaware, was highly protectionist.¹⁵⁶ The prototypical Illinois statute¹⁵⁷ applied not just to companies incorporated in Illinois but to any company whose facilities or shareholders had a meaningful presence within the state. The statute effectively gave the Illinois Secretary of State broad discretion to block acquisition of a targeted company. The protections of the Act had to be triggered by the managers or shareholders of the targeted company, but after that the Secretary of State was free to respond, in addition and more or less as local politics dictated, to appeals from employees and any other local interest groups that were concerned that acquisition of the target company would dis-

152. See, e.g., John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CALIF. L. REV. 1301, 1340, 1366 (2001) (hypothesizing that companies incorporated in Delaware should have more takeover defenses because of the IPO process, and showing that firms incorporated in Delaware empirically have more takeover defenses than the average firm).

153. See Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 624-32 (2003) [hereinafter Roe, *Delaware's Competition*]; Roe, *supra* note 142, at 2510-11.

154. See, e.g., Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 565-66 (2002); Ronald J. Gilson, *Unocal Fifteen Years Later (and What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 502-06 (2001).

155. See Kahan & Kamar, *supra* note 143, at 705-06 & n.86 (noting the interest of corporate lawyers in establishing statutes that require litigation and sophisticated legal advice, and discussing lawyers' efforts to stop a proposed Nevada law reducing officers' and directors' liability to shareholders); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998) (arguing that Delaware is successful at attracting corporate charters because its corporate law is vague enough to give its judges a high degree of power); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 472 (1987) (arguing that the Delaware bar plays an outsized role in determining the content of Delaware corporate law).

156. See Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 234 (1985).

157. Illinois Business Take-Over Act, Pub. Act No. 80-1421, 1978 Ill. Laws 1581 (repealed 1983).

advantage them. It was only when the Supreme Court struck down the Illinois statute¹⁵⁸ that the first-generation statutes were abandoned in favor of the more modest second- and third-generation antitakeover statutes, which generally are limited to companies incorporated within the state and give substantially less discretion to state officials.¹⁵⁹

The most striking evidence of the Olson problem, however, is that legislatures in states other than Delaware have been remarkably willing to grant, with great alacrity, requests from the managers of individual companies—often supported by the company's in-state employees and their unions—for legislation to shield the company from an imminent takeover that is favored by a majority of the company's shareholders.¹⁶⁰

Viewed from this perspective, Delaware corporate law is—like the reformist regimes in other instances of regulatory dualism—complementary to, rather than in competition with, the corporate law of other states. Without Delaware to serve as an escape valve for corporations that want and need a relatively efficient capital markets regime, there would presumably be greater pressure to reform the corporate laws of other states to orient them more strongly toward the interests of noncontrolling shareholders—or, alternatively, to displace parochial state corporation law entirely by nationalizing corporate chartering.¹⁶¹ 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 constituencies with a stake in local firms, including employees and local merchants, 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 corpo-

158. *Edgar v. Mite Corp.*, 457 U.S. 624, 639, 646 (1982) (striking the Illinois statute as preempted by the federal Williams Act and beyond state authority under the dormant Commerce Clause).

159. See WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, *COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION* 604-12 (2d ed. 2007).

160. See, e.g., Henry N. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365, 382-83 (criticizing corporation-specific antitakeover statutes as egregious instances of managers' use of the political process for entrenchment purposes); Kahan & Kamar, *supra* note 143; Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461 (1988) (describing the evolution of state antitakeover statutes); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 122-25 (1987) (noting that the adoption of Connecticut's takeover statute was driven by one major company incorporated in the state); Robert Daines, *Do Classified Boards Affect Firm Value? Takeover Defenses After the Poison Pill* 10-13 (2001) (unpublished manuscript) (on file with authors) (describing how Massachusetts imposed a classified board on all Massachusetts corporations in response to a request by one firm's management for protection from a single acquirer).

161. See, e.g., Roe, *Delaware's Competition*, *supra* note 153 (arguing that the main legal competitor of Delaware is the federal government, not other states).

rate chartering, protectionist political pressures might well produce a body of federal corporate law that is less efficiently shareholder-oriented than is the law of Delaware.¹⁶²

The U.S. system of regulatory dualism in corporate chartering might seem, in contrast to the Brazilian, German, and EU developments described above, not an example of a strategy explicitly 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 *Novo Mercado*, to circumvent long-standing political obstacles to reform. We do not examine here the complex origins of the U.S. chartering system, which involved issues of competition policy¹⁶³ in addition to corporate governance and finance.¹⁶⁴ But its evolution and, particularly, its continuing survival quite plausibly reflect, in important part, its virtues in handling the Olson problem through an effective system of regulatory dualism.

It is clear, in any event, that the U.S. system of corporation chartering, with its liberal choice of law rule, was not dictated by U.S.-style federalism. The legislators and courts that created the U.S. system of general corporate chartering in the late nineteenth century and early twentieth century, and the interest groups behind the legislatures and courts, 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 much of Europe until the last decade.¹⁶⁵ Alternatively, a system of federal chartering could have been adopted that displaced state-level corporate chartering.

The system of bank chartering that developed in the United States in fact incorporated both of those approaches simultaneously, and never developed a system of regulatory dualism. The result, until quite recently, was 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.

162. See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 75-84 (1993); Roe, *supra* note 142, at 2513-15 (using a formal model to illustrate how federal intervention could make the takeover market less efficient).

163. See HERBERT HOVENKAMP, *ENTERPRISE AND AMERICAN LAW 1836-1937*, at 241-67 (1991).

164. New Jersey, which in the late nineteenth century and early twentieth century played the role in corporate chartering now played by Delaware, was attractive to out-of-state companies in part because it, unlike other states, did not restrict corporate combinations that were anticompetitive. New Jersey corporate law was also attractive because it eliminated arbitrary restrictions imposed by other states and focused on protection of shareholders and creditors. See Edward Q. Keasbey, *New Jersey and the Great Corporations*, 13 HARV. L. REV. 198, 205-12 (1899).

165. See *supra* Part II.B.

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2. *Bank chartering*

For most of its history, the U.S. banking industry was a conspicuous exception to the liberal choice of law approach adopted for chartering industrial corporations. Throughout the nineteenth century and most of the twentieth century, nearly all states excluded any bank chartered in another state from doing business within their territory. Indeed, most states went further and also either prohibited or severely restricted *intrastate* branching by banks.¹⁶⁶

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. The losers from the branch banking restrictions, meanwhile, were the firms that could not be established or grow because of the lack of credit, 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.¹⁶⁷ The losing groups were, however, poorly organized in political terms. In short, the U.S. banking industry suffered severely from the Olson problem.

An early effort to break this Olsonian stranglehold began, as Olson would predict, in a revolutionary moment, when the nation was in the middle of the Civil War. Congress provided for the chartering of national banks that would have exclusive authority to issue a uniform national currency. The legislation was expected to effectively eliminate state-chartered banks, and it nearly succeeded. But, when the political equilibrium shifted again after the war, the state banks were once more allowed to flourish under their protectionist state-level chartering regimes, while the newly created national banks were restricted to doing interstate business or maintaining intrastate branches only if state-chartered banks had the same authority under local state law.¹⁶⁸

166. The history of these restrictions is recounted briefly in Geoffrey P. Miller, *Interstate Banking in the Court*, 1985 SUP. CT. REV. 179, 181-83. See also Eugene Nelson White, *The Political Economy of Banking Regulation, 1864-1933*, 42 J. ECON. HIST. 33 (1982) (providing a political economy account of intrastate branching restrictions).

167. Prasad Krishnamurthy, *Branching Restrictions, Financial Market Integration, and Firm Growth: Evidence from U.S. Banking Deregulation* (Aug. 17, 2009) (unpublished manuscript) (on file with authors), provides empirical evidence of the effects of U.S. branch banking restrictions on business growth and surveys the previous literature on the subject.

168. See JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW AND REGULATION* 9-11 (2d ed. 1997); Miller, *supra* note 166, at 181 (discussing federal legislation passed in 1933 “permit[ting] national banks to branch within a state on the same terms and conditions as state banks”).

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 significant relief from the Olson problem in local banking.¹⁶⁹

The consequence was extraordinary fragmentation in American banking until the last decades of the twentieth 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.¹⁷⁰ 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.¹⁷¹

The United States never solved the Olson problem in consumer banking through the mechanisms of political economy, including in particular regulatory dualism. The system of protectionist state-level regulation finally collapsed, in recent decades, principally because of changes in technology that permitted institutions other than banks, as well as banks located in other states, to provide effective competition to state-chartered local banks despite the efforts of the states to shield them.¹⁷²

Why was the Olson problem more resistant in banking than among industrial firms? One reason may be that, given the nature of the legislative restraints on competition in banking, a compromise system of regulatory dualism was difficult to design. Another possible explanation lies in the early structure of the banking industry, which was comprised of large numbers of local banks with relatively homogeneous interests in shielding themselves from competition. Those banks naturally formed a powerful interest group. Industrial companies, being more heterogeneous, constituted a less coherent political force, and hence could do no better than maintain local chartering in the context of regulatory dualism. This reinforces the conclusion—suggested by Brazil’s experience—that regulatory dualism can be an effective approach to mitigating the Olson problem when that problem is only moderately serious, or when it is waning, but not when the elites are truly well dug in.

169. On the lack of real choice of regulation offered by this “dual” system, see Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 678 (1988). Butler and Macey emphasize that maintenance of this inefficient regulatory regime benefited yet another entrenched interest group, namely the regulators. *See id.* at 679.

170. *See* Krishnamurthy, *supra* note 167, at 3.

171. *See, e.g.*, MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 54-59 (1994).

172. *See* MACEY & MILLER, *supra* note 168, at 29-32.

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III. 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 emphasize applications in corporate law, though all these techniques are applied much more generally.

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; firms that had been subject to the preexisting 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.¹⁷³

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.¹⁷⁴ That is, grandfathering can serve as a form of what we described in the Introduction as regulatory diversification. 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 nonvoting preferred shares from two-thirds to one-half of a firm's total capital.¹⁷⁵ The U.S. listing rules that substituted for Securities and Exchange Commission (SEC) Rule 19c-4, barring potentially abusive dual class recapitalizations, also included a broad grandfather exemption for companies with existing dual capital structures.¹⁷⁶ Similarly, New York's 1997 amendment to its Business Corporation Law made a number of changes in voting rules, but specified that the new rules applied immediately only to companies incorporated in New York

173. The two approaches can be combined, as they were by the Novo Mercado in a recent set of proposed amendments to its listing rules. *See infra* text accompanying notes 200-01.

174. *See* 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).

175. Despite their grandfathering protection for old public firms, the new statutory rules were rather timid and were later dwarfed by the Novo Mercado requirements banning nonvoting shares altogether. *See supra* Part I.A-B.

176. *See, e.g.*, NYSE, LISTED COMPANY MANUAL § 313.00 (1994).

after the effective date of the statute; old companies remained largely unaffected unless they affirmatively opted into the new regime.¹⁷⁷

In a non-voting context, India used grandfathering to change a rule that allowed incumbent local businesses to block new foreign investment. A foreign investor who already had a partnership with an Indian company, as was required under Indian FDI rules, was required to secure a certificate from its partner stating that the Indian company did not object if the foreign investor wanted to start a new project in India that was outside the scope of the existing partnership. An Indian company that had an existing joint venture with Disney, for example, is said to have prevented Disney from setting up a Disney cable television channel in India, presumably because it was not to be included. Efforts to eliminate the requirement were challenged both by the Indian Chambers of Commerce and Industry, and by left-wing parties and labor unions. The ultimate resolution, after lengthy delay, was to grandfather existing partnerships but free new joint ventures from the restriction.¹⁷⁸

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 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.

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

178. See TARUN KHANNA, BILLIONS OF ENTREPRENEURS 165-66 (2007).

Third, concerns about disparate treatment before the law can generate hostility toward grandfathering.¹⁷⁹ 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 (e.g., noncontrolling shareholders), in fact erect barriers to entry that shield the established firms from competition.

B. *Menus*

Statutory menus,¹⁸⁰ 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.¹⁸¹ In particular, firms could choose between *kansayaku secchi kaisha* (the traditional Japanese system based on a board of auditors) and *iinkai secchi* (a U.S.-style, board-centered corporate governance regime). 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.¹⁸²

179. See, e.g., MODESTO CARVALHOSA, 1 COMENTÁRIOS À LEI DE SOCIEDADES ANÔNIMAS [COMMENTARIES TO THE CORPORATIONS LAW] 170 (4th ed. 2002) (arguing that the 2001 reform's different treatment of old and new Brazilian firms with respect to preferred shares is inequitable and unconstitutional).

180. On menus in general, particularly in the context of corporate law, see Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3 (2006); and Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination* (Yale Law Sch. John M. Olin Ctr. for Studies in Law, Econ., & Pub. Policy Research Paper, Paper No. 335, 2007), available at <http://ssrn.com/abstract=924578>.

181. See Ronald J. Gilson & Curtis J. Milhaupt, *Choice as Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343, 346 (2005).

182. Robert N. Eberhart, *Corporate Governance Systems and Firm Value: Empirical Evidence from Japan's Natural Experiment 4* (July 2010) (unpublished manuscript), available at <http://sprie.stanford.edu/publications/22480>. 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, illustrat-

Another familiar example of the menu approach in the United States is section 102(b)(7) of the Delaware General Corporation Law.¹⁸³ This section 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*,¹⁸⁴ in response to which section 102(b)(7) was enacted.¹⁸⁵

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.¹⁸⁶

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 commonly done in corporate law by enacting portions of the established regime in the form of default rules 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

ing the existence of an informal item on the menu. *Id.* at 15 ("Noticeably, q-values for both styles of firms decline from 2005 onward and the difference between the medians narrow."). Because the traditional system was sufficiently malleable to allow the adoption of some elements of the *inkai 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.* at 10 ("With the 2005 law, then, a *kansayaku* firm could closely mimic an *inkai* system firm in almost all its essential features."). Thus, depending on the context, informal alternatives may be nested within a menu structure's formal choices.

183. DEL. CODE ANN. tit. 8, § 102(b)(7) (2010).

184. 488 A.2d 858 (Del. 1985).

185. As is widely understood, Delaware corporations had no difficulty making the choice—virtually every company adopted the contemplated charter amendment.

186. See *infra* Part IV.

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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 gives 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.¹⁸⁷ These concerns arguably go far in explaining the remarkable fact that publicly traded corporations in the United States rarely deviate from default statutory law in their charters, despite their great freedom to do so.¹⁸⁸ Paradoxically, contract terms fare worse than legal rules in adapting to new conditions, as the experience with Frankfurt's Neuer Markt shows clearly.

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 non-controlling 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 preexisting 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.

187. Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1, 2 (2006).

188. *See id.* at 4-5; *see also* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 85 (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.¹⁸⁹

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.

IV. 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,¹⁹⁰ those reforms are less than earthshaking; they represent only a modest deviation from Japan's managerialist system of corporate governance and have been taken up by very few companies. And Delaware's menu approach to directors' duty of care quickly collapsed into near meaninglessness: firms almost uniformly adopted exculpatory provisions as permitted by section

189. See *supra* notes 19-21 and accompanying text.

190. See Gilson & Milhaupt, *supra* note 181, at 354.

102(b)(7), while the courts have both retreated from what momentarily seemed to be a higher standard of care and expanded the content of the duty of loyalty (which is not subject to exculpation under section 102(b)(7)) to encompass some obligations previously covered by the duty of care,¹⁹¹ hence arguably removing most of the difference between the old and the new regime.¹⁹²

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 even more U.S. corporate charter business 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.¹⁹³ 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 than Delaware's corporation law. But—aside from an arguably quixotic recent effort in North Dakota¹⁹⁴—we don't see this. Strong forms of regulatory dualism seem

191. In *Stone v. Ritter*, 911 A.2d 362 (Del. 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 classic 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 Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 597 (2008) (describing the Delaware Supreme Court's decision in *Stone* as "another case in which section 102(b)(7) seems to be driving the analysis"); Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1770 (2007) (defending the use of the duty of good faith to enlarge the scope of director liability for breach of the duty of loyalty).

192. For some perspective on the tortured evolution of the duty of care under Delaware law, see William T. Allen et al., *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, 458-65 (2002).

193. 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 H. CHOPER, JOHN C. COFFEE, JR. & RONALD J. GILSON, *CASES AND MATERIALS ON CORPORATIONS* 800-11 (7th ed. 2008) (describing development of the obligation of good faith and fair dealing as an alternative to fiduciary duty). Evidence showing that Delaware corporations going public typically have plain vanilla charters other than with respect to antitakeover provisions, even though the statute allows for substantial variation, suggests that Delaware understands that there is little market for higher standards. See Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 788-91 (2006) (summarizing evidence).

194. Under a 2007 reform to the North Dakota Publicly Traded Corporations Act promoted by corporate governance 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. North Dakota Publicly Traded Corporations Act, N.D. CENT. CODE §§ 10-35,

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 Parts 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.

B. *Dualism via Private Regulatory Organizations*

One alternative is for the reformist regime to be provided by a third-party private or semiprivate organization that is relatively independent of the governmental institutions that provide the established regime. Both Brazil's Novo Mercado 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 its freedom of action. For example, both in the United States 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

54-09-08 (2010). Since firms already incorporated in North Dakota before 2007 are presumably free to reincorporate and thereby take advantage of the new shareholder-oriented provisions, the established and the reformist regimes are available to both old and new firms, making this a straightforward example of regulatory dualism.

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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 Novo Mercado has so far escaped such problems. Whether its enforcement powers will prove adequate to support its rigorous listing standards in the long run—and the extent to which the CVM will continue to play an active role in investor protection—remains 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 their apparent legitimacy and the probability of enforcement of their 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 Novo Mercado (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 require-

ments as contractual in character—provides a cautionary tale for similar institutions, such as Brazil's Novo Mercado.

The ability of the São Paulo Stock Exchange to revise the Novo Mercado's listing rules over time is constrained by the segment's institutional design. Unlike its predecessor Neuer Markt, the Novo Mercado explicitly requires the tacit approval of at least two-thirds of listed firms to any changes in the listing standards. Subject to CVM approval, revisions of the listing rules are binding upon all Novo Mercado firms unless one-third of them expressly oppose the changes during a restricted hearing required under the Novo Mercado regulations.¹⁹⁵ Although this qualified majority approval condition, together with other features of the Novo Mercado, should prevent the courts from treating the Novo Mercado 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 Novo Mercado, 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 significant opposition faced by the São Paulo Stock Exchange in its recent attempt to revise the listing rules of Novo Mercado, Level 2, and Level 1 offers a cautionary tale in this regard. Prior to 2010, the Novo Mercado had an overall positive track record in amending its regulations. The listed firms successfully approved changes to the premium listing standards in late 2005. 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.¹⁹⁶

Since 2005, however, the number of Novo Mercado firms has risen more than fivefold, and the greater number and heterogeneity of listed companies has become an obstacle to sweeping changes to the listing standards.¹⁹⁷ Indeed, the reform process initiated in 2008 has run significantly behind schedule, since obtaining the requisite support from listed firms to the reforms proved to be far more difficult than the Exchange had initially anticipated. Some of the more rigorous amendments initially recommended by a panel of experts appointed by the Exchange met strong resistance from listed firms and were rapidly abandoned.

Despite these concessions and the lobbying efforts of the Exchange, the listed companies still failed to approve the most stringent remaining amend-

195. BM&F BOVESPA, *supra* note 38, § 14.2.

196. Among other things, the stricter amendments, effective as of January 2006, require at least 20% of the directors of Novo Mercado firms be independent. Santana, *supra* note 20, at 32.

197. *See supra* Part II.A.

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ments. The rejected proposals included a new mandatory bid rule triggered by the acquisition of 30% of the firm's outstanding stock (down from 50% under the existing rules), an increase in the minimum percentage of independent directors from 20% to 30%, and the creation of a mandatory audit committee. In commenting upon the outcome of the vote, the board chair of the São Paulo Stock Exchange praised the transparency of the process but regretted the resistance to more expansive reforms as traces of the "old Brazil."¹⁹⁸

Still, the companies approved a number of amendments to the listing rules of Novo Mercado, Level 2, and Level 1 (see Table 3), which overall are a step in the right direction. While the Exchange contemplated the adoption of yet another dualist strategy in case of failure of the revision process—through the creation of a sort of "Novo Mercado Plus," a segment providing for yet more stringent corporate governance standards than the Novo Mercado—this plan has been discarded for the time being.¹⁹⁹ The rejected amendments again posed the Olson problem in this more limited context, with the firms that opposed them having the role of the existing elite.

TABLE 3
Approved Changes to Listing Requirements of Premium
Corporate Governance Segments in Brazil (Sept. 2010)

	Novo Mercado	Level 2	Level 1
Limit on voting caps lower than 5% of total capital (except in privatized companies or as required by law)	Yes	Yes	—
Ban on qualified quorums and immutable charter provisions	Yes	Yes	—
Split of roles of board chair and CEO	Yes	Yes	Yes
Mandatory board recommendation upon a takeover bid	Yes	Yes	—
Adoption of securities-trading policy and code of conduct	Yes	Yes	Yes
Disclosure of securities-trading policy and code of conduct	Yes	Yes	Yes
Deletion of disclosure rules that are now mandatory under new CVM regulations	Yes	Yes	Yes

Note: Subject to CVM authorization

198. Leandro Modé, 'Reforma' do Novo Mercado fica pela metade [Novo Mercado 'Reform' Only Half Successful], O ESTADO DE S. PAULO, Sept. 10, 2010.

199. See Vinícius Pinheiro, *BM&FBovespa descarta criar novo nível de governança* [BM&FBovespa Discards the Creation of New Governance Level], AGÊNCIA ESTADO, Sept. 9, 2010, http://economia.estadao.com.br/noticias/bmfbovespa-descarta-criar-novo-nivel-de-governanca,not_34761.htm.

As a result, the new listing rules as adopted reflect a number of compromises. For instance, the companies' consent to the new listing rule mandating a split in the positions of board chair and CEO appears to be the result of a last-minute amendment authorizing the Exchange to extend the three-year transition period for compliance with this requirement. Other compromises were nevertheless rejected. For instance, the companies vetoed a provision that would prevent new corporations opting for a Novo Mercado listing from adopting overly restrictive mandatory bid requirements in their bylaws—which, by specifying too low a trigger and exorbitant premium requirements, effectively operate as a takeover shield (and are, for this reason, nicknamed Brazilian “poison pills”)²⁰⁰—even though the proposed rule grandfathered existing Novo Mercado firms. This rejection was likely due to fears that grandfathering would stigmatize existing practices and inspire further reforms.²⁰¹ The CVM must now approve the new listing rules before they become effective.

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 go too far in threatening established interests and, as we have seen, the CVM 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, recreating the Olson problem.²⁰²

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

200. See *supra* note 73 and accompanying text.

201. See *supra* Part III.A.

202. 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* 86-93 (Alfred A. Knopf 1993) (1945).

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.²⁰³ And as the general population benefits from economic growth, reform may gain 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.²⁰⁴ In effect, successful reform catalyzes further reform.

Brazil has in fact seen positive legal and regulatory changes following the success of the Novo Mercado, which plausibly were reinforced by Brazil's overall favorable economic performance during this period. These important changes apply to both old and new companies, and came rather sooner than the incumbent firms might have anticipated when the Novo Mercado 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.²⁰⁵ Brazil's 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 freezeout mergers may require the formation of a special committee of independent directors and majority-of-the-minority approval requirements.²⁰⁶ In other words, the controlling shareholder was forced to give up its premium, just the kind of wealth-transfer fear that contributed to the Olson problem in the first place. The CVM 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.²⁰⁷ Likewise, since the launch of the Neuer Markt, and especially

203. 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, 22-23, 80 (2001) (noting the reverse causality between capital markets developments and investor protection laws, as “[s]trong markets do create a demand for stronger legal rules”).

204. See Bebchuk & Roe, *supra* note 62, at 129 (“[T]here are significant sources of path dependence in a country's patterns of corporate ownership structure.”).

205. Lei No. 11.638, de 28 de Dezembro de 2007, D.O.U. de 28.12.2007. 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 segments generally followed the laxer Brazilian GAAP.

206. Parecer de Orientação CVM [CVM Advisory Opinion] No. 35 (2008), available at http://www.bmfbovespa.com.br/juridico/download/ParecerOrientacaoCVM_35.pdf.

207. See Yuki Yokoi, *Happy Preferred Shareholders: Under CVM Pressure, Aracruz PN and ON Get Equal Treatment in VCP Merger*, REVISTA CAPITAL ABERTO, Sept. 2009, http://www.capitalaberto.com.br/english/ler_artigo.php?pag=2&sec=77&i=2584. Yokoi describes the process leading to the merger of Aracruz into Votorantim Papel e Celulose in

after its collapse, Germany has enacted various pieces of investor protection legislation.

Nevertheless, some of the CVM's reform initiatives have run into significant opposition from interest groups. While the CVM has successfully revised most of its regulations on corporate disclosure (which are now stricter than the Novo Mercado standards),²⁰⁸ the rules on executive compensation disclosure fell victim to the Olson problem. After much lobbying from the Brazilian Association of Public Companies during the public hearing stage, the CVM enacted a watered-down provision requiring that companies disclose the aggregate amount paid to executives and board members, as well as the highest and lowest salaries in each category. However, executives have so far successfully challenged this new disclosure requirement in court, obtaining a preliminary injunction to suspend the enforcement of the rule as a violation of the executives' constitutional rights to privacy and security.²⁰⁹ While the final outcome of this controversy remains to be seen, these recent developments highlight the continuing difficulties faced by more traditional modes of regulatory reforms in Brazil.

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 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 again raises the question of why elites did not block reform in the first place. The outcome of the elite's decision calculus²¹⁰ 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

September of 2009. The new company, Fibria, the world's largest pulp and paper company, is expected to migrate to the Novo Mercado. *Id.*

208. See Instrução CVM [CVM Rule] No. 480, de 7 Dezembro de 2009.

209. For a description of the process leading to the adoption of these regulations and of the decisions challenging their legality and constitutionality, see Diego Werneck Arguelhes & Mariana Pargendler, *Collateral Costs of Violence: How Insecurity Is Shaping Legal Institutions in Brazil* (2010) (unpublished manuscript) (on file with authors).

210. See *supra* text accompanying note 5.

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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 will be adopted and succeed depends on the parameter values determined by local conditions. Our analysis identifies 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 mainly avoids this problem, is to have the reformist regime provided by a politically independent foreign government. We have examined two examples of this approach—the United States and the European Union—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 United States, for example, regulatory dualism in corporate chartering has been maintained for over a century.

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, it 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.²¹¹ 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, but could not be successfully established for bank chartering.

211. See Roe, *Delaware's Competition*, *supra* note 153, at 616-20.

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 Novo Mercado, 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 United States were high enough to limit the number of firms that would take advantage of that opportunity.

The creation of the Novo Mercado has spurred the creation and growth of corporations in Brazil well beyond what had been achieved simply through access to listings in the United States, 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 United States have little incentive at present to devote their limited enforcement resources to policing foreign firms, whose transgressions they commonly ignore.²¹² 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.

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. 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 Markt em-

212. See Natalya Shnitser, *A Free Pass for Foreign Firms? An Assessment of SEC and Private Enforcement Against Foreign Issuers*, 119 YALE L.J. 1638 (2009). This is particularly true when the foreign-listed company has few assets in the United States and is therefore practically immune from private enforcement of the securities law.

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phasizes the need for care, effective enforcement, and—as with all human affairs—luck in 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. Indeed, while we have focused here on regulatory dualism as a development strategy in the realm of corporate and capital markets law, it has promise in other important fields as well, from commercial contracting²¹³ to intellectual property²¹⁴ to marriage.²¹⁵

213. See Dammann & Hansmann, *supra* note 49 (proposing to give parties to commercial contracts in countries with weak courts the option of committing to have their disputes adjudicated in the public courts of another country with a better-developed judiciary).

214. The European Union, for example, following the American pattern, now offers a choice between having one's trademark rights governed by an established national legal regime or by the reformist European Union regime. See Julie Bak, *OHIM: The European Community Trademark's PTO*, 19 J. CONTEMP. LEGAL ISSUES 416, 418 n.10 (2010).

215. States in the United States that limit marriage to heterosexual couples but recognize gay marriages entered into in other states offer an example. See David D. Meyer, *Fragmentation and Consolidation in the Law of Marriage and Same-Sex Relationships*, 58 AM. J. COMP. L. 115, 130 n.70 (2010). Another example—involving a menu offered by a single jurisdiction—is the recent creation within three states of a rigorously committed form of “covenant marriage” as an alternative to conventional marriage. See Katherine Shaw Spaht, *Covenant Marriage Seven Years Later: Its As Yet Unfulfilled Promise*, 65 LA. L. REV. 605, 605-06 (2005).

