NAFTA AND MEXICO’S REFORMS ON INVESTOR PROTECTION

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1. Introduction

Three enormously important economic events in the last decades of the 20th century have moved the focus of development to the reshaping of the role of the state to accommodate the needs of a market economy. Institution-building is becoming widely accepted as the principal means of fulfilling this role. The first – perhaps the defining economic event of the end of the 20th century – is the collapse of socialism, and the transition of the economies in Eastern Europe and the former Soviet Union, as well as of China, into capitalism. The second event was catalyzed by the Asian Financial Crises which showed us that the increased interconnectedness in product and financial markets had clear consequences in the spread of shocks across emerging markets. Finally, the third wave of changed started with the increased pace of the European Union and has spread through the establishment of regional trade agreements around the world among developed and developing countries. These three events have started to show that the key question for long-term growth in the new market place is the creation of institutions.

As in other emerging markets, the policy process in Mexico has gone beyond macroeconomic stability, and in the next decade will be critically focused on institution-building. NAFTA, and other free trade agreements that Mexico signed in the previous 8 years, have had the result of lowering tariff and non-tariff trade barriers increasing domestic competition in product markets. Under these circumstances, Mexican firms have found it harder to meet the challenges that increased competition in the local product markets and the potential for a larger market outside of Mexico impose on them. One of the deepest challenges for firms has become the ability to raise capital to meet the investment requirements needed under the new product

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1 This paper has greatly benefited from the work done in conjunction with some of my coauthors such as Juan Carlos Botero, Simeon Djankov, Simon Johnson, Rafael La Porta, Andrei Shleifer, Robert W. Vishny and Guillermo Zamarripa. I want to thank Daniel Lederman, and three anonymous referees for their comments. Finally, I want to thank the insightful comments and help of Jose Caballero and Alejandro Ponce-Rodriguez. Please send comments to Prof. Florencio Lopez-de-Silanes (florencio.lopezdesilanes@yale.edu or 135 Prospect Street, Yale School of Management, Yale University, New Haven, CT, 06520.)
market conditions. In order to raise outside financing, institution-building needs to take place in the area of investor protection. This includes the development of financial institutions such as banks and stock exchanges, development of the legal infrastructure supporting business, and creation of regulatory mechanisms compatible with best world practice.

In this paper, I want to focus on the challenge for long-term growth of an increasingly interconnected economy under freer trade rules: the development of capital markets so that firms can gain access to the external funding needed to undertake investments. The establishment of self-sustainable capital markets has gained particular importance in Mexico as the rate of integration into the global economy has speeded up. Without self-sustainable capital markets, local firms will find it hard to survive, because they will not be able to secure the funding needed to reach the appropriate scale for international competition. The transformation of the role of the state in Mexico through the establishment of free trade agreements and the exit of the government from most industrial production has been the catalyzer for the need to reform investor protection. The recent movement towards securities law and bankruptcy law reform is an example of the wave of reforms that are starting in this area.

The paper is organized in six sections. In the second section after this introduction ("Legal Protection for Investors"), I describe the differences in legal protection for shareholders and creditors in Mexico and a cross-section of forty-eight other countries. Because investor rights are not only determined by law, the third section of the paper ("Enforcement of Laws") compares the quality of the legal enforcement and accounting standards across nations. The ultimate question is whether countries with poor investor protections actually do suffer. If laws and their enforcement matter, then countries that offer entrepreneurs better terms of external finance would have both higher-valued and broader capital markets. The theory also predicts that countries offering entrepreneurs better terms should have widely held corporations. "Consequences of Investor Protection" reviews the evidence on the consequences of poor investor protection for Mexico. This section also compares external finance and ownership concentration across countries as a function of the origin of their laws, the quality of legal investor protections, and the quality of law enforcement. The evidence shows that countries with weaker investor protection suffer greater exchange-rate depreciation and stock market declines when hit by a shock. Through its effects on capital markets, investor protection also influences the real economy.

The fifth section on the feasibility and relevance of reforms in investor protection attempts to answer several questions: What is the evidence on corporate governance reform and its success around the world? Can changes in specific laws significantly affect institutions? Is it particularly effective to change corporation laws, securities regulations, or bankruptcy law? Do these measures need to take account of the efficiency of the judicial system? Do small or large enterprises benefit from reform? What types of investors need reform? Do foreign or domestic investors care about reforms? After answering these questions, section 6 analyzes the current efforts of reform in the wake of NAFTA and proposes an agenda of reforms to develop and strengthen Mexico’s stock and credit markets.

Section 7 of the paper studies the evidence of corporate governance reform in the rest of Latin America making a connection to its current degree of openness and to the implications of the potential Free Trade Agreement of the Americas. Finally, in the last section entitled "Conclusions and Policy Implications for the potential Free Trade Agreement of the Americas," discusses the policy implications of the results. Capital markets are a key ingredient for sustainable development. Therefore, the reform of financial-markets regulations that has naturally started in Mexico as a result of the pressure of increased interconnectedness via freer trade, should be explicitly included among the key areas to foster the integration of Mexico and other Latin American Economies in the region through the FTAA. As the evidence from the
European Community shows, successful economic integration of lower per-capita-income countries like Spain, Portugal, or Greece needs to be tied to mechanisms that foster institutional development. It is only through the development of efficient institutions that these countries can secure the basis for sustainable long-run development. Freer trade itself creates the need for the transformation of financial institutions and investor protection, therefore the need to explicitly promote these reforms as part of the agreements.

2. Legal Protection for Investors

Why are there large differences in the size, breadth, and valuation of capital markets? Why, for example, are equity markets so much larger in South Africa than in Mexico or Peru? Why do many companies go public in India and Hong Kong every year, while only a handful of firms go public in Mexico or Turkey? Why do countries like New Zealand have large credit markets with hundreds of firms issuing public bonds while Mexico and the Philippines do not?

In a simple Modigliani-Miller framework the size of capital markets is determined only by the cash flows that accrue to investors. Therefore, the size of capital markets should be roughly proportional to Gross National Product (GNP). To explain the large discrepancies in the size of financial markets across countries with similar GNP, we need to recognize that securities are more than the cash flows they represent, because they entitle investors to exercise certain rights. Shares not only entitle investors to dividend payments, but also to exercise control over management through the voting process. Similarly, debt not only entitles creditors to receive interest payments, but also to regain their collateral in the event the firm goes bankrupt.

The separation between ownership and control can have a large effect on the size of capital markets once we depart from the Modigliani and Miller assumptions and allow for the existence of agency costs. To take an extreme view, outside equity would have no value if shareholders did not have control rights to force managers to pay out dividends. In the same vein, creditors would be unwilling to lend money at any interest rate if their control rights did not allow them to punish debtors who default on their financial obligations. Both financiers and management would benefit from the elimination of the agency conflict if they could write a complete contract that specified what managers should do with the funds and how they would give funds back to investors under all potential circumstances. Of course, a complete contract cannot be implemented in practice, making it necessary for management to have a level of discretion. Management discretion, although a cost-effective way of dealing with the separation of ownership and control, can unfortunately be used to expropriate financing through outright theft, transfer-pricing, or asset-stripping.

A legal approach based on the agency model could, in principle, explain why some countries have much larger capital markets than others, because legal protections for investors differs enormously from country to country. For example, shareholder rights in Mexico differ greatly from the shareholder rights in the United States; furthermore, the shareholder's recourse to redress is likely to be significantly weaker. The legal approach predicts larger capital markets

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in countries where agency costs are reined in by the law and the institutions support their enforcement.\textsuperscript{4}

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) assembled a data set covering legal rules pertaining to the rights of investors, and to the quality of enforcement of these rules, for forty-nine countries with publicly-traded companies. Laws tend not to be written from scratch, but rather to be transplanted—voluntarily or coincidentally—from a few legal families or traditions. In general, \textit{commercial} laws come from two broad traditions: common law and civil law. Most English-speaking countries belong to the common-law tradition based on the British Company Act. The rest of the world belongs to the civil-law tradition, derivative of Roman law, which has three main families: French, based on the Napoleonic Code of 1804; German, based on Bismarck's Code of 1896; and Scandinavian, which legal scholars describe as less derivative of Roman law but “distinct” from the other two civil families.

The common-law family includes former British colonies, such as the United States and Canada, and other nations such as Thailand and Israel which modeled their initial corporation laws on the laws of England. There are eighteen common-law countries in the sample. The French legal family includes France, Spain, Portugal, and their colonies. There are twenty-one French legal origin countries in our sample, including Mexico and eight other countries in Latin America. The German tradition has had less influence, and we have only six countries in this family: Austria, Germany, Japan, South Korea, Switzerland, and Taiwan. Finally, the Scandinavian family includes the four Nordic countries of Denmark, Finland, Norway, and Sweden.

There are numerous differences among company and bankruptcy laws in different countries. We focus on those basic rules that scholars believe to be essential to corporate governance.\textsuperscript{5} Furthermore, it is beneficial to restrict our attention to those basic rules that are pro-investor.

\textbf{A. Shareholder Rights}

Shareholders have residual rights over the cash flows of the firm. The right to vote is the shareholders' main source of power. This right to vote in the general meeting to elect directors and make major corporate decisions guarantees shareholders that management will channel the firm’s cash flows to shareholders through the payment of dividends rather than divert the funds to pay themselves higher compensation, undertake poor acquisitions or take other measures not


in the interest of shareholders. Therefore, voting rights and the rights that support voting mechanisms are the defining features of equity.

Appendix A provides a detailed description of all the variables used in this paper, and Table 1 presents the evidence on shareholder rights for the cross-section of forty-nine countries. A useful way to begin the discussion of shareholder rights is to assume the role of an investor in a U.S. firm and then become an investor in a Mexican corporation. This also illustrates the differences between a legal systems based on English common law and on French civil law.

The first column of Table 1 shows that not all U.S. shareholders have the right to vote. That is probably a bad thing, because when votes are tightly linked to capital contributions, it is more difficult to control a company by having just a small fraction of the equity. Yet, as it turns out, one-share-one-vote rules are uncommon everywhere—including Mexico and Canada.

The next six columns of Table 1 provide different measures of how strongly the law governing corporations protects minority shareholders against oppression by managers or dominant shareholders. These rights are thus labeled as “anti-director” rights. The first four anti-director rights measure how easy it is for an investor to exercise any voting rights that she may have. Shareholders in the United States will receive proxy statements two weeks in advance of the shareholders’ meeting with detailed information on the items to be discussed at the meeting. They do not need to show up in person at the meeting—they can mail their proxy vote instead. The shares of investors who have indicated that they will participate in the shareholders’ meeting will not be blocked in the days prior to the meeting, because the freedom to trade shares before shareholders’ meetings is an important right for people who may want to form alliances to challenge management proposals. Directors are not necessarily chosen one at a time through a majority vote, and thus shareholders are entitled to have proportional representation or cumulative voting for directors. Our hypothetical investor has the right to call an extraordinary shareholders meeting (ESM) to consider a resolution if he owns 10 percent of the share capital.

The next right listed in Table 1 measures the protection of minority shareholders against a particular type of expropriation: issuing shares at favorable prices to, for example, associates of the controlling shareholders. Out of the six rights in this table, this is the only one that shareholders in U.S. corporations do not have. The law does not guarantee shareholders a preemptive right to buy new issues of stock in their holdings. Finally, U.S. investors who feel they have been hurt by the decisions of the majority can seek redress through the courts. When the court believes that oppression has indeed taken place, it may order that the oppressed members’ shares be bought out at a fair price or that the firm remedy the matters at issue. More generally, best-practice countries such as the United States provide legal mechanisms for the protection of oppressed minorities. To give just another example, a dissenting investor in Chile has the right to request—at the meeting—that the firm buy back his shares at the market price prevailing before the meeting.

In Mexico, as in the United States, not all shares are endowed with the same right to vote. However, unlike in the United States, investors in Mexico are not usually sent detailed information about the agenda when they are notified of forthcoming shareholders’ meetings. Only by going to the meeting will they know what is discussed. In fact, attending the meeting—or designating someone to do so in their place—is the only way in which they can vote; proxy by mail is not allowed. Furthermore, announcing that they intend to vote their shares will cause them to be blocked, making it impossible for them to trade the shares in the days surrounding the meeting. At the meeting, shareholders vote on the slate of directors proposed by management and are not allowed proportional representation on the board. Investors in Mexican firms must have at least 33 percent of share capital to have a resolution considered by the ESM. Fortunately, investors in Mexico do have a preemptive right that prevents dilution. Regrettably, this is the only right (of those that we collect) that shareholders in Mexico have, because they do not have
any legal recourse against the decisions of the majority. To summarize, Table 1 paints a very bleak picture of shareholder rights in Mexico.

A convenient way of summarizing shareholder rights is to aggregate anti-director rights into an index, adding 1 if the corporation law protects minority shareholders, and a zero otherwise. For the case of the percentage of share capital needed to call an ESM, we give a 1 to those countries where this percentage is at or below the world median of 10 percent. When we add up these six anti-director rights scores, the United States and Canada have a score of 5 while Mexico’s score is only 1.

A corroboration of the findings in this table can be exemplified by the opinions of various institutions that advise institutional investors around the world. As Table 2 illustrates, associations such as Investor Responsibility Research Center and Institutional Shareholders Services argue that corporate practices of Mexican firms are not best-practice. (See Table 2 for some examples.)

The comparison between Mexico and the United States illustrates the broad findings of Table 1: Shareholder protection in common-law countries is significantly better than in French civil-law countries. While the incidence of one-share-one-vote rules, cumulative voting for directors, and preemptive rights are not statistically different across English and French legal systems, the remaining four measures show marked differences. Common-law countries more frequently allow shareholders to exercise their vote by mail than French-origin countries (39 percent vs. 5 percent). No common-law country blocks shares before shareholders’ meetings, while 57 percent of French civil-law countries do. On average, 9 percent of the share capital is sufficient to call an ESM in common-law countries, whereas 15 percent of share capital is required in French civil-law nations. Finally, 94 percent of common-law countries have an oppressed minority mechanism in place, while only 29 percent of French-origin countries do. The differences between English- and French-origin countries are captured in the anti-director’s index, which has an average of 4.00 for common-law countries and only 2.33 for French civil-law nations (t-statistic of 4.73).

German civil-law countries share the French-origin lack of protection of shareholder rights. Although German-origin countries have a significantly higher incidence of oppressed minority mechanisms, they block shares more often than French countries do. The average anti-director scores for the German and French families are the same (2.33). Finally, Scandinavian-origin countries, although inferior to common-law countries in shareholder protection, are the best within the civil-law tradition. The average Scandinavian anti-director rights score is 3. In short, relative to the rest of the world, common-law countries have the package of laws most protective of shareholders.

**B. Creditor Rights**

In principle one would like to measure the ability of creditors to use the law to force companies to meet their credit commitments. In practice, creditor rights are difficult to assess for two main reasons. First, most countries have in place both reorganization and liquidation procedures that are used with varying frequency and may confer different levels of protection to creditors. For example, a country may be very protective of creditors if it offers strong rights in liquidation and weak protection in reorganization, provided that the reorganization procedure is seldom used. Second, creditors, unlike shareholders, do not have a homogeneous claim against the firm—i.e., they differ in the priority of their claim. As a result, it is possible that measures that favor some creditors (e.g., unsecured creditors) may hurt others (e.g., secured creditors).

To undertake a cross-country analysis of creditor rights, Table 3 scores creditor rights in both reorganization and liquidation, and adds up the scores to create a creditor-rights index, in part because almost all countries rely to some extent on both procedures. In assessing creditor
rights below, the table also takes the perspective of senior secured creditors, in part for concreteness, and in part because much of the debt in the world has that character. Once again, to illustrate differences between English common-law countries and French civil-law countries, we describe the data by comparing the rights of an investor who has given credit to a firm incorporated in the United Kingdom, considered best-practice in terms of creditor rights in the world, versus the rights of an investor who has given credit to a firm incorporated in Mexico.

Suppose that a debtor to whom the creditor has lent money files a petition for reorganization in London. The court will then notify the creditor, who will have two weeks to oppose reorganization. A secured creditor who chooses to oppose a reorganization petition has the right to appoint a so-called trustee to decide what will happen to the firm. The important thing is that the debtor does not have the right to unilaterally file for reorganization. Even if the borrower’s petition for reorganization is accepted, there is not an “automatic stay” that prevents a secured creditor from gaining access to her collateral. In addition, secured creditors who choose not to withdraw their collateral are paid first in the event that reorganization fails and liquidation ensues. Finally, the bargaining position of creditors is strengthened by the fact that pending the resolution of the bankruptcy procedure, the old management team will not continue to run the firm. Rather, a trustee appointed by the creditors would be in charge of the firm’s day-to-day operations.

Now suppose that a debtor to whom the creditor has lent money files a petition for reorganization in Mexico City. Creditors have no say in whether the firm’s reorganization petition is accepted or declined. But if the petition is accepted, secured creditors cannot pull their collateral out of the firm; rather, an “automatic stay” is triggered by the acceptance of the reorganization petition. Secured creditors have additional worries, because if liquidation takes place, they are not paid first. Rather the state and the firm’s employees take priority. The creditors’ predicament is aggravated by the fact that the debtor not only writes the reorganization proposal, but continues to run the firm pending the resolution of the bankruptcy procedure, which will likely take several years.

As with shareholders, one way to summarize the difference in creditor rights across countries is to create an index that adds 1 when the pro-investor right is granted by law, and zero otherwise. This index is shown in the last column of Table 3 and takes a value of 4 for the United Kingdom and zero for Mexico. Again, as with shareholder rights, the picture for creditor rights in Mexico is substantially bleaker than in the United Kingdom.

Although the Mexico-U.K. comparison is extreme, common-law countries in general offer creditors stronger legal protections against managers. Table 3 shows that all four measures of creditor rights are weaker for countries of French legal origin by an amount that is statistically significant. 72 percent of common-law countries place restrictions on managers seeking court protection from creditors, compared to only 42 percent of French civil-law nations. The incidence of having no automatic stay on assets is 72 percent in common-law countries versus only 26 percent in French civil-law nations. Relatively fewer countries of French legal origin (65 percent) assure that secured creditors are paid first than countries of English legal origin (89 percent). Finally, only 26 percent of French civil-law countries remove managers in

6The rights coded in this document are those of the Mexican Bankruptcy and Reorganization Law that was in effect until May 2000. That month, the Mexican Congress approved a new law that will change some creditor rights. For our purposes, which is to measure the effect of laws on the development of Mexico’s debt markets, it is correct to codify the law in effect for the last thirty years, because the rights in that law are the ones generating the outcomes. In fact, the score for Mexico would not change if we codified the creditor rights embedded in the new Mexican Bankruptcy and Insolvency Law.
reorganization, compared with 78 percent of countries of the common-law family. In brief, the average aggregate creditor rights score is 3.11 for English origin and a mere 1.58 for French origin.

As Table 3 shows, the United States and Canada do not score particularly high in terms of creditor rights. This is one of the main reasons why various groups have repeatedly demanded a reform of current bankruptcy laws: it is thought that Chapter 11 (reorganization) provides too many advantages to debtors and fails to protect creditors. As we will see below, the problem of poor creditor protection in terms of legal rights in the United States and Canada might be alleviated with good judicial enforcement, which is not the case for Mexico.

German legal origin countries are relatively more pro-creditor than French civil-law countries, averaging an aggregate score of 2.33. The differences between German- and French-origin countries are particularly significant in liquidation measures: 67 percent of German civil-law countries have no automatic stay and always pay secured creditors first.

Finally, countries of Scandinavian origin always pay secured creditors first, but always allow management to stay pending reorganization. In three out of four cases they impose an automatic stay on assets and place restrictions on reorganization. As a result, the aggregate creditor-rights index for countries of Scandinavian legal origin has a value of 2.00—a difference that is not statistically significant from the 1.58 value for countries of French legal origin.

To summarize the results thus far, bankruptcy laws differ a great deal across countries. In particular, they differ because they come from different legal families. Relatively speaking, common-law countries protect creditors the most, and French civil-law countries—Mexico in particular—protect them the least. German and Scandinavian civil-law countries are in the middle. The one exception is the strong protections that German civil-law countries afford secured creditors.

3. Enforcement of Laws

Legal rules are only one element of investor protection; the enforcement of these rules may be equally or even more important. If good laws are not enforced, they cannot be effective. Likewise, investors may enjoy high levels of protection despite bad laws if an efficient judiciary system can redress expropriations by management. In this way, strong legal enforcement may serve as a substitute for weak rules.

Table 4 presents several categories for the quality of enforcement of laws in different countries. These measures are collected by private credit-risk agencies for the use of foreign investors interested in doing business in the respective countries. (The agencies include Business International Corporation and Political Risk Services). Table 4 shows three measures: efficiency of the judicial system, rule of law, and corruption. The first two of these proxies pertain to law enforcement, while the last one captures the government’s general attitude toward business. In addition to these measures, the table also shows data on the quality of accounting standards of publicly-traded firms in different countries. Accounting is central to corporate governance, as it may be difficult to assess management performance without reliable accounting standards. More broadly, cash flows may be very difficult to verify in countries with poor accounting standards, consequently, the menu of financial contracts available to investors may be substantially narrower in such countries. The index of accounting standards in Table 4 is provided by the Center for International Financial Analysis and Research based on examination of company reports of firms in each country. It is available for forty-one of the forty-nine countries in the sample.
Compared with the English-origin average, as well as with Canada and the United States, Mexico has very weak legal institutions and accounting standards. Mexico’s scores for all enforcement variables are below the world’s average. In fact, Mexico ranks between the thirtieth and fortieth in the world, from top to bottom, for these measures. Mexico shares poor enforcement with the rest of the French legal family which has the weakest quality of legal enforcement and accounting standards. Note that rule of law is the only measure where differences in means between common law and French legal origin are not statistically significant. Scandinavian countries have the strongest enforcement mechanisms, with German civil-law and common-law countries close behind. Common-law countries, although behind Scandinavian nations, are still ahead of the French civil-law countries.

These results do not support the conclusion that the quality of law enforcement substitutes or compensates for the quality of laws. An investor in Mexico—and more generally in a French civil-law country—is poorly protected by both the laws and the system that enforces them. On average, the converse is true for an investor in a common-law country. Poor enforcement and accounting standards aggravate, rather than cure, the difficulties faced by investors in French civil-law countries. The weak scores obtained by Mexico in shareholder and creditor rights may actually understate the severity of the corporate governance problem in Mexican corporations.

4. Consequences of Investor Protection

There are at least two reasons why legal institutions may have no effect on the pattern of external financing of firms. First, laws may not be necessary to support external financing if, for example, companies keep their promises not because they are forced to but because they want to build a good reputation to facilitate their access to capital markets. Their reputations unravel if the gains from cheating ever exceed the value of keeping external financing open, because investors, once they employ inductive reasoning, would never extend financing to such a firm to begin with.

Second, poor laws and their enforcement may have no real consequences if firms can easily opt out of the laws of their legal jurisdictions. Easterbrook and Fischel question whether legal rules are binding in most instances, because entrepreneurs can offer better investor rights, when it is optimal to do so, through corporate charters that effectively serve as contracts between entrepreneurs and investors. In practice, however, opting out may be costly both for firms that need to write non-standard contracts and for investors who need to study them. In addition, courts may be unwilling or unable to enforce non-standard contracts, further limiting the scope for opting out.

Alternatively, if legal institutions matter, ownership concentration should be higher in countries with poor investor protection than in countries with strong protections for investors for at least two reasons: First, agency problems may call for large-scale shareholders to monitor managers and thus prevent or minimize expropriation. Second, minority shareholders may be unwilling to pay high prices for securities in countries with weak legal protection. At the same time...

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time, entrepreneurs will be more reluctant to offer shares at discounted prices, thus resulting in higher ownership concentration as well as smaller and narrower markets for external equity. Similarly, bad creditor rights may have analogous price and quantity effects on debt markets. In other words, if laws do not protect the rights of creditors, debt markets may be small because creditors may demand high interest rates. Moreover, firms may be reluctant to borrow from arm’s-length sources in such conditions.

Ultimately, the question of whether legal institutions matter is fundamentally empirical: If opting out were cheap and simple, the patterns of ownership and external finance of firms would not be affected by differences in legal institutions across countries. Accordingly, in this section, we examine two types of evidence regarding the influence of legal institutions on external finance: ownership concentration, and the size and breadth of capital markets. Table 5 summarizes the results.

A. Ownership Concentration

The first striking result of Table 5 is that in the world as a whole, dispersed ownership is a myth: In a typical top–ten firm in the world, 45 percent of the common shares are held by the three largest shareholders. The second result is that those countries with weaker investor protections have larger share ownership concentration. In particular, countries of the French legal family have an average ownership concentration of 55 percent. Statistically this number is significantly higher than the mean for the rest of the world and for the mean for each of the other three legal families individually.

Like the rest of the French origin, Mexico has highly concentrated ownership. With the exception of Chile, which has strong shareholder rights, all Latin American countries in the sample have higher ownership concentration than the world mean. After Greece and Colombia (68 percent), Mexico has the third-largest ownership concentration level in the world (67 percent). In sum, these data indicate that Mexico has unusually high ownership concentration, possibly as an adaptation to weak legal protection.

B. The Size and Breadth of Capital Markets

Several interesting patterns emerge from looking at our categories for external equity finance in Table 5. First, access to external equity financing is most limited in countries such as

9Ownership concentration per se may be efficient, because the existence of large-scale shareholders monitoring management reduces the agency problem between management and shareholders; see Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," Journal of Financial Economics 3 (October 1976), pp. 305–60; and Andrei Shleifer and Robert W. Vishny, "Large Shareholders and Corporate Control," Journal of Political Economy 94 (June 1986), pp. 461–88. But large-scale concentration comes at a cost, because it creates another agency problem: the expropriation of minority shareholders' stakes by large-scale shareholders. An additional cost of heavily concentrated ownership is that the core investors are not diversified.

10To measure ownership concentration, a 1998 study assembled data for the ten largest publicly traded, non-financial private domestic firms in each of forty-five countries. For each country the study measures ownership concentration as the median percentage owned by the three largest shareholders in each of these ten firms; see La Porta, Lopez-de-Silanes, and Vishny, December 1998.

11This paper uses the three measures of equity finance developed in Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, “Legal Determinants of External Finance,” Journal of Finance 52 (July 1997), pp. 1131–50. The first measure is the 1994 ratio of external equity finance to GNP.
Mexico and the rest of the French civil-law countries. Specifically, the ratio of external capital to GNP is roughly half the world mean and one-third of that in the United States. Meanwhile the ratio of domestic firms to total population is between 10 and 15 times lower than the world mean and the U.S. number. Finally, the ratio of Initial Public Offerings (IPOs) to population is roughly thirty to fifty times lower than the equivalent number for the world mean and for the United States. In contrast, all three equity measures indicate that, on average, access to external equity is easiest in common-law countries: The ratio of outsider-held stock market to GNP is 60 percent, vs. 40 percent for the world mean; the number of listed firms per 1 million people is 35, vs. 21.6 for the world mean; and the number of IPOs per million people is 2.2, vs. 1.02 for the world mean. Finally, equity markets in countries of Scandinavian origin are smaller but broader than in countries of German origin. To summarize, external equity markets line up rather well with shareholder rights and legal institutions: They are smallest in French civil-law countries and largest in common-law countries.

The fifth column in Table 5 shows the aggregate debt measure. The ratio of total debt to GNP is 45 percent for French civil-law countries, 57 percent for Scandinavian countries, 68 percent for common-law countries, and 97 percent for German countries. Mexico, with a ratio of total debt to GNP of only 47 percent, is at an approximately average level within the French civil-law family. Low creditor rights line up with small markets when we compare countries with French, Scandinavian, and English legal systems. A partially mitigating force in the area of debt markets and their connection to creditor rights, comes from two characteristics of bank in each country. To compute a rough proxy of external equity finance, they multiply the total market value of common stock of all publicly traded firms by the average fraction of the equity not held by the largest three investors (i.e., the complement of the ownership variable just described). They scale the total market value of common stock by the fraction of equity held by minority shareholders to avoid overestimating the availability of external financing. For example, when 90 percent of a firm’s equity is held by insiders, looking at the market capitalization of the whole firm gives a tenfold overestimate of how much it has actually raised externally. The procedure followed may still overestimate the level of external financing, because the ownership concentration figures are based on the largest firms and because they ignore cross-holdings. Still, this procedure is conceptually better than looking at the ratio of market capitalization to GNP.

The remaining two measures of external equity finance capture market breadth. The first is the number of domestic firms listed in the stock exchange of each country relative to its population. The second is the number of initial public offerings of shares in each country between mid-1995 and mid-1996, also relative to the population. They look at both the stock and flow of new companies obtaining equity financing, because the development of financial markets has accelerated greatly in the last decade, and hence the IPO data provides a more recent picture of external equity financing.

12As in LaPorta, Lopez-de-Silanes, Shleifer, and Vishny, July 1997, this paper measures the availability of debt financing in each country as the ratio of the sum of private-sector bank debt and corporate bonds outstanding to GNP. The choice of debt variable is partly determined by data availability, because the analogue of the stock market data used to measure external equity financing does not exist for debt markets. However, the fact that the debt measure includes not only corporations but the whole private sector may actually be an advantage, because in many countries entrepreneurs raise money on their personal accounts to finance their firms (for example, by mortgaging their properties).

13A possible explanation of the German-origin anomaly is that firms in both Germany and Japan have large liquid assets and, therefore, the debt measure overstates their true liabilities; see Raghuram Rajan and Luigi Zingales, "What do we Know about Capital Structure: some Evidence from International Data," Journal of Finance 50 (December 1995), pp. 1421–60.
ownership. First, government ownership of banks is higher in countries with French civil law origin (La Porta, Lopez-de-Silanes and Shleifer, 2002). Second, related lending is a common practice in many countries as a result of privatization programs that restricted the ownership of banks to domestic investors (La Porta, Lopez-de-Silanes and Zamarripa, 2003). These two forces may mitigate the impact of creditor rights on the size of debt markets since these two types of shareholders do not necessarily obey market forces or care about the probability of repayment by the borrower.

The differences among countries described in this section are supported by regression results on all of these outcome variables, which include the indices of investor protection, legal enforcement, and control for country characteristics.

C. The Depth of Collapses

Although the evidence reviewed above suggests that expropriation of investors is endemic, it does not imply that there is a zero cost of stealing. Furthermore, expropriation may be of particular importance as a cause of prolonged and deep collapses.

One of the implications of the previous section is that weaker legal institutions lead to fewer projects being financed. Weak legal institutions can also contribute to economic crises. Weak protection of investor rights does not make shocks more likely, but it does enlarge the negative effect shocks have on the overall economy. For this reason, institutions matter for a particular aspect of volatility after collapses. Reasonable corporate finance arrangements in a weak legal environment can lead to a bimodal distribution of outcomes; i.e., either the economy does well or it collapses.

Investor protection may have effects on macroeconomic outcomes. If expropriation by controlling investors increases when the expected rate of return on investment falls, then an adverse shock to investor confidence will lead to increased theft, to lower capital inflow, and greater attempted capital outflow from a country. These, in turn, will translate into lower stock prices and a depreciated exchange rate.

This hypothesis is examined in Johnson et al., who analyze the depreciation of currencies and the decline of the stock markets in twenty-five countries, including Mexico, during the Asian crisis of 1997–98.14 Their results show that investor protection indices and especially the measures of the quality of law enforcement are powerful predictors of the extent of market declines during the crisis. In fact, these variables explain the cross-section of declines much better than the macroeconomic variables that have been the focus of the policy debate. Again, the empirical evidence bears out the implications of the theory.

D. Real Consequences

A large literature links financial development to economic growth. King and Levine initiate the modern incarnation of this literature by showing that countries with better developed capital markets grow faster in the future.15 Subsequent work extends these findings.16 Some of

these papers show that the association between external finance and growth holds even at the
industry level. Others show that an exogenous component of financial market development,
obtained by using legal origin as an instrument, predicts economic growth.

Through its effect on financial markets, investor protection influences the real economy.
There is a large amount of literature that ties financial development to economic development.
Financial development can accelerate economic growth in three ways. First, by raising
opportunities, financial development can enhance savings, particularly if new products are
developed. Second, it can channel these savings into real investment and thereby foster capital
accumulation. Third, to the extent that the financiers exercise some control over the investment
decisions of the entrepreneurs, financial development improves the efficiency of resource
allocation, as capital flows toward the more productive uses. All three channels can in principle
have important effects on development.

Along this line of thought, Beck, Levine, and Loayza find that banking sector
development exerts a large impact on total factor productivity growth, and a less obvious impact
on private savings and capital accumulation. Moreover, this influence continues to hold when
an exogenous component of banking sector development, obtained using the origin of the legal
system as an instrument, is taken as a predictor. Wurgler finds that financially developed
countries allocate investment across industries more in line with industry-related growth
opportunities than do the financially undeveloped countries. This research suggests that the
improvement in resource allocation is an important consequence of financial development, and
that through this channel, investor protection can benefit the growth of productivity and output.

5. Corporate Governance Reform

The previous sections have two broad implications. First, they show that the most
developed financial markets are protected by regulations and laws. However, they do not tell us
what the best form of regulation is, which may well include self-regulation as well as
government regulation. Still, totally unregulated financial markets do not work well, presumably
because they allow corporate insiders to expropriate too much from outside investors. One
dramatic illustration of this phenomenon is the fact that the most sought-after place for listing by
publicly held companies around the world happens to be New York—a heavily regulated
exchange when it comes to disclosure and protection of minority shareholders—rather than
Mexico City.

Second, improving the functioning of financial markets through the protection of outside
investors has real benefits both in terms of overall economic growth and for the allocation of
resources across sectors. The analysis in the previous pages suggests that the objective of
corporate governance reform in most countries should be to protect outside investor rights,
including both shareholder and creditor rights. As the empirical research shows, the benefits of
such reform would be to expand a country’s financial markets, to facilitate external financing of

Economic Review, vol 88, no 3 (June 1998), pp. 559-586; Ross Levine, “Law, Finance, and
Economic Growth,” Journal of Financial Intermediation, vol 8, no 2 (April 1999); and W. Carlin
College, 1999].
17 T. Beck, R. Levine, and N. Loayza, “Finance and the sources of growth,” Journal of
Economics, vol 58 (October 2000), forthcoming.
new firms, to move away from concentrated ownership, and to improve the efficiency of
investment allocation. What can be done to achieve this goal, and what are the obstacles? This
analysis raises a number of questions for reform. How can a policymaker try to improve
markets? What are good reforms? What type of firms are likely to benefit from corporate
governance reform?

A. Possibilities of Legal Reform

In the last decade, the reform of corporate governance has preoccupied policymakers all
over the world, from Western to Eastern Europe, Latin America and Asia. The proposals of how
to improve governance have covered a broad range of areas. The Cadbury Committee focuses on
the reform of the boards of directors. The European Corporate Governance Network stresses
improved disclosure as a useful reform strategy. In the aftermath of the emerging-markets crisis,
several Latin American and Asian countries are reforming regulations covering bankruptcy,
disclosure, and several other aspects of governance, yet there the progress has been rather
tentative as well.

To organize this discussion, it is useful to follow Coffee in drawing a distinction between
legal and functional convergence. Legal convergence refers to the changes in the rules and in
enforcement mechanisms toward some desirable standard. To achieve legal convergence to
effective investor protection, most countries require extensive legal, regulatory, and judicial
reform. Alternatively, functional convergence refers to more decentralized, market-based
changes, which do not require legal reform per se, but still bring more firms and assets under the
umbrella of effective legal protection of investors. I discuss these two alternative paths of reform
in turn.

Coffee argues that there is an important movement towards “functional convergence,”
through which firms around the world are adopting U.S.-type mechanisms to protect investors.
There is certainly a move towards issuing American Depositary Receipts (ADRs), and these
seem to improve access to external capital markets. An ADR is equivalent to listing a foreign
country’s securities on an exchange that protects shareholders, mainly through stricter
disclosure requirements. This, in fact, is done by many companies when they list their shares as
ADRs in New York. Such a listing in New York (or London), supported in part by the threat of
delisting, raises the level of shareholder protection.

Lins, Strickland, and Zenner show that the sensitivity of investment to cash flow falls
when an ADR is issued by a company from a country with a weak legal system and a less-
developed capital market (as defined by La Porta, Lopez-de-Silanes, Shleifer, and Vishny). Reece
and Weisbach show that companies in civil law countries are more likely to list ADRs on an organized exchange in the United States, thus committing to greater disclosure. In
particular, Mexico is the country with the highest percentage of locally listed firms that have
ADRs in the United States. Close to 38 percent of all Mexican firms listed on the Mexican Stock

19 J. Coffee, “The future as history: the prospects for global convergence in corporate
20 Karl Lins, Deon Strickland and Marc Zenner, Do non-US firms Issue equity on US Stock
Exchanges to Relax Capital Constraints? Mimeograph, University of North Carolina at Chapel
Hill, January 2000
21 La Porta, Lopez-de-Silanes, Shleifer, and Vishny, July 1997.
22 Michael S. Weisbach, and William A. Reese, Protection of Minority shareholder interests,
cross-listings in the United States, and Subsequent Equity Offerings, Mimeograph, University of
Illinois Department of Finance.
exchange have some listing in the U.S. stock markets. The geographic proximity between Mexico and the US may be part of the explanation, but the cross-country evidence supports the view that in countries with weak investor protection, firms try to find ways to access external capital markets.

A related mechanism of opting into a more protective legal regime is an acquisition by a company already operating in such a regime. When a U.S. company acquires a Mexican company, the possibilities for legal expropriation of investors diminish. In a friendly acquisition, the controlling shareholders of the Mexican company can be compensated for the benefits they lose, making it more likely that they will go along. Such acquisitions enhance efficiency, because the wasteful expropriation is replaced by publicly shared profits and dividends. Some of the acquisitions in the NAFTA region, as well as in the European Community in the last few years, reflect this particular phenomenon.

In summary, the mechanisms of functional convergence, particularly those taking the form of opting into the more protective legal regimes, are moving assets to the countries which give investors a stronger claim to them. This movement should facilitate the development of external finance in many countries. However, such "opting in" cannot fully replace *bona fide* legal reform. International contracts can get around some of the deficiencies of domestic investor protection, but they cannot solve them, as shown in the previous sections. The majority of Mexican firms cannot reach the scale necessary to access U.S. markets and are therefore left with the local financial markets as their only potential source of finance.

Most companies in Mexico, particularly the smaller growth companies, are in desperate need of external funds but not ready to list in New York or to be acquired. Furthermore, cross-border acquisitions are politically sensitive. Even for those firms that do have access to ADRs, the listing does not solve the problem completely, because the insiders still have a variety of ways of taking advantage of shareholders open to them (and presumably utilize them, for why would they give up their private benefits in exchange for a mere listing?). Even if the insiders violate the listing rules, the threat is a fine or being delisted from the exchange, in the worst case. Opting in may well be the politically feasible solution to the problems of legal reform, but it is by no means a fully adequate solution.

Another important limitation of functional convergence is in the area of creditor rights. Assets located in particular countries generally remain under the jurisdiction of these countries' laws. Without bankruptcy reform, opt-in mechanisms are unlikely to address the legal problems faced by domestic, and especially foreign, creditors.

For most countries, Mexico included, the improvement of investor protection would require rather radical changes in the legal system. Securities, company, and bankruptcy laws would generally need to be amended, and the regulatory and judicial mechanisms of enforcing shareholder and creditor rights would need to be radically improved. There is no reason to think that the particular list of legal protections of investors is either necessary or sufficient for such reforms. In principle, some mechanisms—such as giving shareholders the right to a quick redress mechanism or a class-action suit against directors—could work powerfully even in an environment where other shareholder rights are missing. On the other hand, the evidence presented in previous sections is clear that the historical origin of the country's legal system plays a key role in shaping investor rights. In turn, the status of investor rights could be considered representative of the law’s general stance toward outside investors, and suggests at least tentatively that many more rules will need to be changed simultaneously in countries with poor investor protection.

Effective legal reform in Mexico, as in many other countries, runs into tremendous political obstacles. Perhaps the most important objections come from the controlling shareholders at the top of large corporations. The reason for that is straightforward. From the
point of view of the controlling investors, an improvement in the rights of outside investors is first and foremost a reduction in the value of control, as opportunities deteriorate. This is so despite the fact that the total value of these firms increases as a result of legal reform, as expropriation declines and investors finance new projects on more attractive terms.

There is perhaps a further reason why the insiders of major firms oppose corporate governance reform and the expansion of capital markets. Under the status quo, the existing firms can finance their own investment projects through internal cash flows as well as relationships with either captive or closely tied banks. In fact, the lion's share of credit in Mexico goes to the few largest firms: 18 percent of all private claims in the Mexican economy go to the largest 20 private firms listed on the stock exchange. This number is twice as high as the world mean and almost three times as high as in the United States or Canada. As a consequence, the large firms not only get the finance they need, but also the political influence that comes with the access to such finance, as well as security from potential competition that would come when smaller firms could also raise external capital. When new entrepreneurs have good projects, they often have to come to the existing firms for finance. Poor corporate governance delivers the insiders not only secure finance, but also relatively secure politics and markets.

In a country like Mexico, opposition to reform also includes opposition by labor interests. After all, these interests are also receiving some rents from the existing arrangements, for example when managers invest in large plants that are irrelevant and employ large numbers of people. The losers in the existing arrangements are the new entrepreneurs who cannot raise external funds to finance new investment, and the parts of the labor force that do not have access to the privileged jobs.

Consistent with these apparent difficulties of reform in the context of interest group politics, the successful reforms have only occurred when the special interests could be destroyed or appeased. In this respect, corporate governance reform is no different from most other reforms in developing or developed countries. 23

Although difficult, reform has taken place in several countries, such as the United States in 1933–34, Japan after World War II, Chile in the 1980s, and more recently in Germany, Korea, and Poland. These examples illustrate the possibility of legal reform in the area of investor protection, but also point to the substantial political difficulties. Yet there are some countervailing political interests as well, including foreign (institutional) shareholders and creditors, who have recently begun to insist on having some rights as investors. In some countries, these outside investors are beginning to have influence. Their influence becomes particularly great in the times of financial crisis, such as the emerging world has experienced in 1997–98, when companies and the insiders who run them desperately needed funds. Indeed, Thailand has recently introduced a new bankruptcy law, and Korea has allowed outside investors to successfully sue the directors who act against their interests. It remains to be seen how far these efforts go. Slow and difficult as it is, real legal reform needs to take place in Mexico. But what parameters should that reform follow?

B. Who benefits from Corporate Governance Reform?

There are two key questions concerning the object of corporate governance reform: (1) what type of firms benefit from it? And (2) which investors need protection? The first question emerges from the misunderstanding that corporate governance only deals with those issues that affect the large firms listed in the stock exchanges. This is a complete fallacy: poor corporate governance is more damaging for medium and small size firms, precisely because they are the ones that do not benefit from the monitoring of the market and the reputation that being a listed

firm entails. Medium firms with some possibility of entering the market find it very hard to make that jump precisely as a result of poor investor protection. Small and medium firms, with higher risk and scarcer information, will hardly ever be approached by foreign or local investors who fear expropriation from the controlling shareholders. Many scholars believe that corporate law is crucially important for non-publicly traded firms, where conflicts of interest arise with large frequency.

In terms of the kinds of investors that need protection, Berglof and Von Thadden suggest that although poor protection is likely to deter small investors, small investors are not always likely to play an important role. This might lead us to believe that investor protection may not be necessary in countries where small investors are unimportant, such as Mexico. But the effectiveness of large investors (shareholders or creditors) also depends on the degree of legal protection. All non-controlling investors—large or small—need their rights protected.

Poor investor protection also deters strategic investors, “modest-size,” and large shareholders. Although large shareholders are able to monitor management actions more closely and thus solve the free-rider problem that affects small investors, the large investors still need legal protection of their voting rights. Some examples from developing countries and transition economies help illustrate this point. In most joint ventures in Mexico and other developing countries, it is common practice for the foreign partner to write a “shareholders’ agreement” to protect her rights. Strategic investors need the courts to enforce these agreements; otherwise they are unwilling to share their technological know-how.

Poor investor protection also deters creditors. Creditors need clear bankruptcy procedures and courts that enforce the law in order to be able to repossess collateral. The absence of creditor protection deters the development of the financial sector. For example, the evidence in Levine shows that moving a country from the lowest quartile in terms of creditor protection to the next quartile translates into a 20% rise in financial development, which accelerates long-run growth by almost one percentage point per year. La Porta, Lopez-de-Silanes, Shleifer, and Vishny show that creditor protection leads to large debt markets. Creditors have less power in Mexico and other French civil-law countries because the procedures for turning over control to the banks are not clear. Countries such as Mexico, Greece, or the Philippines have poor creditor protection and poor legal enforcement, and as a result have small and concentrated debt markets.

Finally, it is important to point out that foreign and domestic investors are for the most part equally affected by poor corporate governance. The effects of poor investor protection may be stronger for foreign investors as they understand less of the business practices in the other country and may give a higher price to legal certainty. An area where the negative effect on foreign investors may impose a large cost to the economy is in direct investment through joint ventures. In these cases, valuable opportunities for technology-transfers and growth enhancing joint ventures simply do not take place as a result of the fear that the minority partner will be expropriated by the controlling local investor. This has the consequence of preventing ventures that could not only increase production of those firms in the venture, but also help in the positive externalities created by the process of the transfer of technology that is typically associated with these ventures.

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26 La Porta, Lopez-de-Silanes, Shleifer, and Vishny, July 1997.
The implication of the legal approach to corporate governance is that a method of financing develops when financiers are protected by the law and its enforcement. The key issue is that poor protection of investors deters not only very small investors, but also strategic investors, large and modest-size shareholders, and creditors.

6. The experience of Corporate Governance Reform in Mexico:

As Table 6 shows, capital markets in Mexico have not followed the upward trend of the economy and their behavior does not correspond to one’s priors about the opportunities that NAFTA represents for future growth. The table shows that during the last decade, the stock market has been staggering in some measures or shrinking in some others, as in the case of the number of listed firms. The number of delistings outpaces that of initial public offerings. These circumstances, coupled with the pressures from the convergence in the real sector are some of the key reasons why reform has started to take place.

What can policymakers do to foster better investor protection? There are several types of corporate governance reforms at work in many countries, and the evidence suggests that some of these efforts have important effects on investor protection and the financing of firms. Some mechanisms might be appropriate for Mexico, though others might not work, given current enforcement environment. Unfortunately, our understanding of the principles of reform of investor protection remains limited. There is no checklist of what needs to be done. However, the available evidence indicates that reforms to foster financial markets in Mexico must meet four tentative principles:

- Legal reform is slow and complicated; therefore, complementary market-based mechanisms should be adopted, because they can help create the necessary pressures for reforms to take place.
- Rules do matter. It is not just the stance of the law or the political sentiment that shapes financial markets.
- The enforcement of legal rules is deeply connected with the rules themselves.
- Potentially more controversial, government regulation of financial markets may be useful when court enforcement of private contracts or even of government laws cannot be relied on.

With these principles in mind, there are seven policy recommendations that form the agenda for deepening Mexico’s financial markets. I will classify these measures into two groups: (1) mechanisms that allow market forces to create a culture of investor protection; and (2) legal reforms that create rules which reduce the room for discretion.

A. Market-based Mechanisms

As explained above, legal reform may be slow and complicated. Therefore, market-based mechanisms should be designed to temporarily substitute or complement the reform of laws and regulations. These measures should be a set of public measures that facilitate competition and ratings, making it possible for the firms that adhere to such measures to access capital at lower cost. At the same time, these mechanisms also have the objective of extending/publicizing the concept of better corporate governance practices. The adoption of such measures should constitute a useful first step in Mexico as they will foster the culture of respect for investor protection and set the basis for the coming legal reform.
Committee on Best Corporate Governance Practices

The lack of investor protection also has cultural causes. The Mexican “Committee on Corporate Governance,” created in January 2000, is an ideal measure to promote the development of a culture of respect for investor protection among entrepreneurs. Mexico has followed the example of Australia, New Zealand, and England, which established commissions formed by members of the private sector and government to review corporate practices and investor protection. In each of these countries, the committee in charge of the analysis produced a document called “Code of Best Practices,” detailing rules of good corporate governance mechanisms and investor protections. These codes are mainly concerned with the organization of the board and special committees, but in the case of Mexico (probably as a result of the current lack of investor protection), the code also details several shareholder protections.

The philosophical principle underlying these codes is that the disclosure of information about corporate governance practices and investor protections by the firm allows the market to perceive the differences among the policies followed by various companies. Information should allow shareholders to distinguish those firms that adhere to investor protections, in turn making the shareholders more willing to give the companies funds. In the end, those firms with better practices should find it easier to access capital and at lower cost, as they provide a more certain environment for the investor.

The adoption of the principles of the Code of Best Practice in Mexico, as in most other countries, is voluntary, but the disclosure by each firm in the stock is compulsory. Starting with fiscal year 2000, all publicly-traded firms on the Mexican Stock Exchange must state in their annual report to the shareholders which rules of the code they follow, and which they do not. They may state why they do not follow the rules they have elected not to follow, and describe any alternate mechanisms they may have for the protection of investors. The experience of other countries shows that adopting the code starts movement toward modernizing investor protection because it is equivalent to an agenda of reforms shareholders could submit to the board or at the shareholders’ meeting.

This code is a substantial step forward in the creation of a culture of investor protection, as it allows investors: (1) to distinguish firms that do have effective corporate governance mechanisms in place; and (2) to reward firms that offer better protection with higher valuation multiples or lower costs of capital. Recent developments at TV Azteca, the second-largest television chain in Mexico, illustrate this point. Accused of poor corporate practices, TV Azteca decided to be among the first in Mexico to adopt all the recommendations of the code. Its efforts have not gone unnoticed as Institutional Shareholders Services, one of the largest U.S. advisors to pension funds, as one of the eight firms in the world that adopted substantial changes in its corporate governance practices in the world in 2000.

More generally, although compliance to the disclosure of practices has been virtually universal (see Table 7), the adherence to the Code’s principles has not been as large. The areas where less than half of the firms in the market have adopted the standards of the code are those of board composition, independence of the audit committee, the existence of a committee of compensation and evaluation, the disclosure of compensation schemes for executives.

One of the largest benefits of the Code of Best practices is precisely the fact that it allows us to make the analysis that sheds clearer differences between firms within the country. This also provides a reform guideline for shareholders and improves the image of those companies that uphold the Code. Although this is a step forward, the Code has clear limits as it is only a guideline that applies to publicly traded firms. On top of this limitation, the initial deficiencies in terms of the vagueness of some principles and the fact that director’s responsibilities are not clearly spelled out, have become more pronounced in the wave of corporate scandals in the U.S. in the area of related transactions. There is a clear need for the Code to be revised leading to a
permanent Committee that has as its mission the improvement and adaptation of the Code to the changing corporate environment

**Alternative Markets with Higher Standards**

The positive effects of Code of Best Practice illustrate the second principle of successful reform mentioned above: rules do matter. Germany’s Neuer Markt is an excellent example, as well as an additional policy recommendation. In Mexico and in many European countries, there is a perception that their stock markets do not attract initial public offerings, and that this slows the development of new high-technology firms. There has been considerable debate about how to address this issue, but the main problem is that established firms like the existing rules\(^{27}\) which allow them to raise capital on favorable terms, in part because they do not have to compete with new firms.

Germany, however, has experimented successfully since 1997 with the Neuer Markt, a sub-exchange of the Frankfurt Stock Exchange created especially for new firms wishing to go public.\(^{28}\) Corporation law, the securities law, and other basic laws and regulations applied to the companies listed there are the general German rules. The politics are German as well. However, the Deutsche Bourse has mandated that companies wishing to list on the Neuer Markt must comply with international accounting standards (U.S. GAAP or IAS), which include, in English, more stringent disclosure requirements than those applicable to already listed firms. The major effect of this new market has been to allow new firms easier access to the market: more than two hundred firms have gone public in the past three years, more than during the first fifty years after World War II.

Korea, despite a relatively weak legal system, has recently implemented the German-type approach. Most of the companies choosing to list on this market (KOSDAQ) have clear ownership structures and, at least so far, there have not been significant allegations of expropriation by these firms.

In Mexico, a new listing venue—with U.S.-style rules and greater restrictions on entrepreneurs—may accelerate the pace of initial public offerings. The powerful titans of Mexican industry may accept it because their firms are not affected, pointing to one possible strategy for overcoming political opposition to reform.

**Prudential Measures for Institutional Investors**

Enhanced disclosure requirements may not be sufficient in countries with weak legal institutions or where investors have very few rights, which prevent them from demanding changes. In such instances, as in Mexico, it may be desirable to restrict institutional investors to investments in companies that meet minimum corporate-governance standards. These standards may be determined in relation to the code of best practices or by independent best-practice commissions.

This recommendation is based on purely prudential reasons as well as on the need to create an incentive for firms to agree on better investor protection. A similar idea has been implemented in Chile, also a civil law country, where a commission detailed a large list of minimum requirements that issuers of securities must meet in order to be the object of investment by institutional investors (Decree No. 3.500 in Chile).

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**State-Controlled Enterprises**

Finally, among those decentralized measures I recommend that the State improve the corporate governance practices for those firms that still have participation. Despite widespread privatization in Mexico, there are still close to 150 state-controlled enterprises. These firms could set the example for private firms by adopting better investor protections.

Most of the state-run firms in Mexico are large public utilities or in natural resources. External funding is just as important for them, if not more important, than for private firms, because of substantially reduced government expenditures. They need higher levels of investment to meet the demand from the growing private sector. Therefore, it becomes imperative for them to find mechanisms to fund their projects from capital markets. Reform of corporate charters and improved investor protection would also alleviate the government budget constraint. The adoption of the code of best practices outlined above can provide a quick and easy way for these state-controlled firms to substantially transform themselves and secure access to funds at better rates.

**B. Legal Reforms**

As the evidence in this paper shows, the law and its enforcement are a good predictor of the development of capital markets. We also see that although the market-based mechanisms outlined above may help foster the growth of external funding, they have limitations. They do not solve all the problems with investor protection as they only reach a small group of firms that are either already in the stock market or that belong to the State. There are also limits to what can be obtained by improved disclosure and voluntary adoption of higher investor protection standards. Even in the best-case scenario, firms might adopt improved protections with non-standard contracts, but when violations occur, enforcement of the contracts may be harder in weak legal systems. For these reasons, market-based mechanisms should be complemented with legal reforms whose effects can reach all firms and can be more easily enforced as the standard in the country.

The design of successful legal reforms in Mexico needs to take into account the weakness of the legal system. This area illustrates the third principle mentioned above: the enforcement of legal rules is deeply connected with the rules themselves. The strategy for reform is not to create an ideal set of rules and then see how they can be enforced, but rather to enact the rules that can be enforced with the existing enforcement structure.

**Securities Regulation**

The new Securities laws tries to refocus regulation so that supervision is concentrated on intermediaries, rather than on issuers. This idea is sometimes credited to James Landis, a contributor to the 1933 and 1934 Securities Acts in the United States.\(^\text{29}\) Landis reasoned that regulators by themselves could hardly monitor the compliance with disclosure, reporting, and other rules by all listed firms, and the trading practices of all market participants. Rather, the commission would regulate intermediaries, such as the brokers, the accounting firms, the investment advisors, etc., who would in turn attempt to assure compliance with regulatory requirements by the issuers and the traders. Moreover, by maintaining substantial power over the intermediaries through its administrative relationships, including the power to issue and revoke licenses, the commission could force them to monitor market participants.

The principle of bringing private intermediaries into the enforcement of securities regulations has since been followed by a number of countries in their regulation of financial

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markets, including Germany and Poland. In Poland, for example, stringent and toughly enforced regulations concerning intermediaries have stimulated rapid development of securities markets and enabled a large number of new firms to go public. In contrast, during the same period of time in the Czech Republic, a very similar country, the lax—and laxly enforced—regulations have been associated with the stagnation of markets, the delisting of hundreds of privatized companies from the stock exchange, and virtually no new listings. These findings suggest that smarter regulations, particularly in countries with relatively weak legal systems, such as Mexico, can improve the protection of investors, and that this improvement will help firms to obtain external finance.

The most recent “Tag along rules” and the virtual creation of a Takeover law in Mexico are the newest impetus in this area. As a result of a few recent scandals which involved domestic and foreign buyers through purchases of controlling blocks of publicly traded shares, the Mexican authorities have passed some of the most stringent rules in Takeovers around the world. Basically based on the United Kingdom model, the new rules try to make sure that differential treatment of investors will not take place through acquisitions of control.

The code protects minority shareholders to a far greater degree than was previously the case, by requiring public tender offers when more than 30% of voting capital is accumulated by an investor. The rules gives all shareholders full 100% tag along rights in such public tender offers, irrespective of the class or number of shares they own. Overall these rules level the playing field between majority and minority shareholders in change of control situations, and thus should boost the value of minority stock. Important winners are minority shareholders in so-called takeover plays companies in Mexico that offer important strategic value to foreign or local investors, since minorities will be able to sell at 100% of the price as majorities. The main points of the new regulation are the following:

1) Require a partial public tender for shares when an acquirer seeks to own more than 30% of the voting capital of a quoted company. The acquirer would have to tender for the higher of the increase in his ownership (at least 30% of he had no shares to begin with) or at least 10% of the capital stock (if he had, for example, 25% of the company before and sought to increase ownership to 30%). In such a tender there would be full 100% tag along rights for all shareholders irrespective of the share series owned, and pro rata scale back if more shares are tendered than the acquirer seeks to buy.

2) Require a full 100% public tender if an acquirer sought to increase (or establish) his ownership beyond 50% of the voting capital - unless the board of directors and audit committee shows that maintaining a public float is in the interests of minority investors and the Mexican SEC grants an exemption. As above, such a tender has to be made to all shareholders, irrespective of the share series owned, and all would be able to sell at the same price in the tender (and would be scaled back pro rata if the 100% tender offer exemption was granted).

3) Automatic 100% tender offer is mandated should the float fall below 15% after a tender.

4) In addition, the regulations stipulate how tender offers are to be carried out, require reporting requirements when investors increase their position in a stock beyond 10% (and require a new report every time their positions increase by an increment of 5%), and require insiders to report buying or selling stock for more than US$150,000.

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every quarter.

Enforceability is always an issue with such codes and the Mexican regulation does leave
the door open for some potential problems since it allows the regulators powers to intervene in
some decisions. But overall, the movement is clearly on the positive side.

**Corporate Law**

The successful regulation of the U.S. securities markets, the Polish financial markets, and
the Neuer Markt in Germany share a common element, namely the regulatory insistence on
extensive disclosure of financial information by the issuers. But this point illustrates why
securities regulations alone, which basically focus on disclosure, may need to be complemented
with changes in the corporations law of the country to give shareholders the rights to act on the
information they receive. A right to act appears to be a key element of their protection.

As illustrated in previous sections, Mexican shareholderes’ rights are among the worst in
the world. In order for improved disclosure standards to have an effect, the current “Ley de
Sociedades Anónimas” of the Commercial Code must be revamped. In some instances, this
might require refining existing principles to make them more applicable. In other cases, it is
necessary to create rights that are easily enforceable. The reform of Mexican corporation law
may not need to follow the U.S.-type mechanisms that rely heavily on the judicial system, by
means of derivative or class-action suits. Instead, once one recognizes the state of the legal
system, the application of more “automatic” principles, such as some of those in Chile, may be a
better answer for Mexico. The reform of Mexico’s corporate law must include the following
shareholder rights:

1. Increase information available prior to the shareholders’ meetings and simplify
   procedures for attending such meetings.
2. Increase the ease of voting and expressing opinions different from those of the
   managers and controlling shareholders.
3. Create a mechanism to allow qualified minorities to submit proposals to be discussed
   at shareholders’ meetings.
4. Allow proportional representation on the board of directors for minorities with at
   least 10 percent of the shares.
5. Guarantee non-discriminatory treatment of minorities by allowing a semi-automatic
   procedure that permits dissenting minorities to be compensated if the controlling
   shareholders approve actions that are detrimental to the corporation and in their own
   favor (as in the case of Chile).
6. Define fiduciary obligations and judicial responsibilities of officers and board
   members.
7. Regulate conduct in cases of conflicts of interest.
8. Reinforce internal auditing procedures and committees for material transactions.

**Bankruptcy Law**

The importance of enforcement is also illustrated by the so-far unsuccessful reforms of
bankruptcy procedures in Latin American and East Asian countries. In general, improving
bankruptcy procedures is more difficult than improving shareholder rights because different
types of creditors, unlike the different non-controlling shareholders, have different objectives.
Senior creditors, especially the secured senior creditors, prefer rapid liquidation of bankrupt
corporations. Junior creditors and shareholders, whose claims are less secure, may prefer more orderly
liquidation or even reorganization. These conflicts have pushed most countries to opt for slow,
reorganization-focused bankruptcy schemes rather than liquidations.  

Another complication is that bankruptcy procedures almost inevitably rely on significant adjudication by the courts. Yet courts in many countries are reluctant to play too active a role in matters as political and complicated as closure or liquidation of companies. In the aftermath of the Asian crisis, several East Asian countries, including Indonesia, Korea, and Thailand, have reformed their bankruptcy laws. Yet few companies have been taken through the bankruptcy process so far, largely because courts are politicized and not ready to adopt the new procedures. They tend to throw out most creditor applications—especially those against powerful borrowers—on technicalities.

For this reason, one may want to emphasize bankruptcy procedures that minimize the involvement of courts. The United Kingdom’s bankruptcy procedure puts most of the discretion in the hands of creditors rather than in the courts. Another departure from current practice would introduce market forces into the bankruptcy process by auctioning off bankrupt firms much in the same way that state-owned enterprises are currently privatized.  

The reform of Bankruptcy and Insolvency laws is under severe political pressures form all sorts of fronts. A further difficulty is that this area of reform is tougher as it usually involves the reform of the whole mechanism, as opposed to certain principles or articles of the law in corporate or securities laws. In May 2000, Mexico adopted a new bankruptcy law addressing some of the main deficiencies of its prior legislation, but it still falls short in key areas. Unfortunately, as in other cases in East Asia and Latin America, the reforms adopted amount to a wasted opportunity: if one looks at the basic creditor rights in Table 3, Mexico scores the same before and after the reform.

Although the law does make a large effort including numerous time limits for several procedures, the discretion and decision powers are still not in the hands of creditors but in those of judges and a new breed of regulators in an entity supposed to coordinate the process. This is particularly important for countries with poor enforcement and high corruption. Although the U.S. and Canada have poor creditor protections in their laws, the enforcement and level of corruption are much lower than in Mexico, thus creating a better environment where the decisions allocated to third parties different from creditors.

The result of the shortcomings in the new Mexican bankruptcy law are reflected in the fact that there are almost no cases brought to court as people are simply not using the law. A well functioning mechanism is one that allows firms with negative economic NPV project to exit the market in an organized fashion. This is not what is being observed in Mexico after the reform.

For bankruptcy reform to be effective, it is essential that the regulation of the new law tries to address some of the main shortcomings of the current reform and includes mechanisms that achieve the following six points:

1. Minimize the transaction costs of the process and the discretionary ability of third parties, such as the judiciary.
2. Facilitate firms' access to credit in order to foster productive investment.
3. Ensure that the assets of the firm are used efficiently, either through reorganization or

31 Hart, Oliver, Different Approaches to Bankruptcy, mimeograph (Cambridge, MA: Harvard University, November 1999)

liquidation.
4. Preserve the absolute priority of creditors.
5. Allow creditors holding collateral to repossess their collateral in due course and before other creditors benefit from it.
6. Maximize the payments to all those investors that provided financing to the firm.

An efficient bankruptcy procedure is essential to expand credit access and restore the stability of the banking sector. Without essential creditor rights, the future functioning of credit institutions in Mexico is compromised. An effective bankruptcy law is essential to secure the flow of funds to small and large firms. While ADRs allow firms to partially escape poor securities laws, as the regulations that apply are those of the stock market where the securities are issued. But in the case of credits, the ultimate law is the bankruptcy law of the country where the assets are located. This means that it is virtually impossible to escape a poor bankruptcy law and a poor court enforcement of such law. A poor bankruptcy law has a similar negative impact for small, medium and large firms.

7. Corporate Governance Reform in the Rest of Latin America

The increased liberalization of trade and non-trade barriers and the threat and discipline that foreign competition exerts on local firms has started to increase the awareness of the importance of good corporate governance in several Latin-American countries during the past few years. One country after the other, they have established commissions for the study of the topic and drafted various proposals of bills and regulations. Some countries have gone even further, by enacting legal reforms aimed at tackling some of the most pressing issues. Yet, despite increased awareness, ample discussion, and growing literature, results are still very timid. Part of the results may be explained by the fact that Free Trade of The Americas may not be regarded by some as a real possibility, or simply by the strong forces of opposition in many of these countries. With the single exception of Chile, an economy with large trade openness, the laws of all Latin-American countries still provide very limited shareholder protection, which results in comparatively small and closed capital markets.

Chilean law has maintained consistently high standards of protection in various areas of shareholder and creditor protection for a long period of time. Similarly, high disclosure requirements for issuers wishing to attract institutional investors—that other countries in the region are now copying—have been in place in Chile for many years. Recent changes have only consolidated this trend. The financial community enthusiastically welcomed a new shareholders’ rights law enacted in 2000, which significantly improved the protection of minorities and institutional investors. The main changes introduced by the new law include: (i) mandatory tender offers after certain ownership thresholds; (ii) the obligation to extend pro-rata to minority shareholders any deal entailing a change of control; (iii) a reduction of the percentage of shares required to call an extraordinary shareholder’s meeting, from 10 to 5%; (iv) appraisal rights when the majority of the company’s assets are sold or collateralized; (v) the ban for directors to vote on related-party transactions; and (vi) the obligation for large companies to have a three-member audit committee.

All other Latin-American countries lag far behind Chile in terms of corporate governance development. The general picture of corporate governance reform in Latin-America during the

33 La Porta et al (1997)
34 Latin Finance (Feb., 2001)
past few years is still one of intensive talk but very shallow reform efforts, which are not likely to have a profound impact—if any at all—in the capital markets. However, all countries are not at the same stage of evolution—some of them have already adopted very meaningful first steps in the right direction, while others have not even engaged in a serious discussion of the topic.

During the past two decades, the Brazilian government did not worry about minority investors. Whether or not minority shareholders lost money, Brazilian laws kept encouraging large investors to buy control of companies at big premiums and then lower the purchase price by offering to buy the shares held by helpless minorities. As a consequence of this poor protection, business began to migrate to Wall Street. Table 8 shows the collapse in the volume traded in Brazil and the other two major Latin American markets. This hardly squares with the high activity of Latin ADRs who rank amongst the top ten more active in New York.

Last year, in an attempt to staunch the flow of business to New York, the Brazilian government started implementing a reform agenda, which introduces some of the most advanced guidelines on corporate governance in the region. Perhaps the most important improvement involves the introduction of the “Novo Mercado,” a forum for companies that voluntarily agree to adopt corporate governance standards higher than those required by Brazilian law. This follows closely the movement in Germany and Korea explained in the previous section. To gain entry into the Novo Mercado, companies must issue only voting shares, they must have outside directors on the Board, and abide by international accounting standards; also, minority shareholders must receive the same treatment as controlling shareholders in the event of a takeover. The reform, however, may not stop the migration of business to New York. Traders say that transaction costs in Brazil are two and three times higher than they are in the U.S. markets (see Table 8). So far only very few firms have listed their shares in the highest-protection levels of the new scheme. Some investors believe there will not be a flourishing equity market for small and medium-sized companies until more bank credit and venture capital becomes available for these companies to finance their early stages.

Colombia is another country that has taken some serious steps towards improving corporate governance. In 2001, the Superintendency of Securities required companies to adopt good governance codes and to certify compliance with stringent disclosure and stakeholder protection requirements to be eligible for pension funds’ investments. But the reform movement lost momentum this year when the discussion of a new securities law bill proposed by the same Superintendency was postponed in Congress. According to local media, large economic conglomerates fiercely opposed the proposed full-disclosure scheme in Congress. The other major aspects of Colombian shareholder and creditor protection remain within Latin-American standards. For instance, proxy voting is rudimentary—there is no mechanism in place to enable an effective proxy contest—and the right to call an extraordinary shareholders’ meeting requires 25% of the shares. Additionally, corporate law does not include detailed regulations on independent directors and board committees, and courts have been unable to develop an alternative doctrine that could fill in the legislative gap. In the area of bankruptcy law, a new reorganization procedure introduced two years ago only focused on preventing bankruptcies, rather than protecting investors.

Ecuador is among the countries in Latin America that does not seem to be engaged in meaningful corporate governance reform. A restatement of the corporate laws that took place a

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36 Botero and Lopez-de-Silanes (2002)
couple of years ago did not introduce any meaningful changes in shareholder protection. And the last two years only witnessed cosmetic changes, such as the elimination of the mandatory nature of the legal reserve. A draft for a new corporate law is currently under discussion in Ecuador, but it seems to be only a superficial amendment to the current system, since the bill does not tackle any of the main issues in corporate governance reform. Similarly, the movement towards a new corporate reorganization law does not seem to be inspired by the idea of enhancing investor protection but by trying to prevent bankruptcies. The reluctance to change might be explained by the extremely closed nature of Ecuadorian companies—88% of the top 1000 companies are owned by 10 or less shareholders.\textsuperscript{37} Moreover, since firms are too small to migrate, there is no driving force pressing for reform. This creates a vicious circle of protectionism of majorities that hampers the development of the capital market.

Argentina is another example of poor investor protection and lack of substantive reform movement. A bankruptcy law introduced this year did not make significant improvements, and company and securities laws remain very favorable to controlling shareholders. It is not surprising to see the collapse of the capital market that is currently taking place in the country, and the migration of firms to New York and other venues. Argentina represents an interesting case as most firms and groups have been completely swallowed by foreign firms as a result of the lack of access to funds to face the next phase of increased competition in a more open market. A large fraction of firms in the stock exchange have delisted as the new foreign owners see little benefit from quoting in the Buenos Aires exchange (see Table 8).

Finally, the area of dispute resolution is another major hurdle for stakeholder protection in Latin-America. Judges generally lack the sophistication and resources needed to effectively enforce shareholder and creditor’s rights, courts have not developed a clear concept of fiduciary duty, and controlling shareholders may expropriate minorities through complex mechanisms without violating the law. Moreover, litigation is extremely slow; the average duration of a civil case in ordinary courts is of several years in most countries.\textsuperscript{38}

8. Conclusions and Policy Implications for Potential FTAA

In this paper, I have looked at the new challenges in the area of investor protection imposed by the changes brought about by the last decades of the 20\textsuperscript{th} century. The increased interconnectedness of product markets through freer trade and explicit agreements of economic integration in the area of trade impose real pressures for the development of institutions that secure financing for firms that need to survive under the new rules. In order to show the benefits of improved financial institutions, I surveyed the laws governing investor protection, the quality of enforcement of these laws, and their effect on the availability of external financing across countries. Based on this evidence, the last two sections of the paper have outlined the possibilities for legal reform in Mexico and other countries in the Latin American region and an agenda for successfully increasing investor protection and thus deepening financial markets in the region. The analysis suggests five broad conclusions:

First, investors in different legal jurisdictions have very different bundles of rights. Therefore, investor rights are not inherent to securities but rather are determined by laws. In particular, French civil-law countries, including most of Latin America, protect investors the least, while common-law countries, such as the United States, protect them the most.

\textsuperscript{37} Superintendencia de Compañías (2001)
\textsuperscript{38} Djankov et al (2002)
Second, law enforcement differs a great deal around the world. Mexico, Latin America and other French civil-law countries have the worst quality of law enforcement and accounting standards, which are critical for investor protection.

Third, the evidence suggests that large capital markets require countries to protect financiers against expropriation by entrepreneurs and to provide good enforcement mechanisms to exercise such rights. In the absence of a good legal environment, financiers are reluctant to surrender funds in exchange for securities, and hence the scope of capital markets is limited. Specifically, we see evidence that weak legal institutions result in high levels of ownership concentration, low availability of external equity financing, narrow equity markets, and small debt markets.

Latin America, and Mexico in particular, offers investors a rather unattractive legal environment. Both, shareholder and creditor rights, as well as the quality of enforcement, lag behind common-law origin countries. As a result, credit markets are exceedingly small, and stock markets are both small and very narrow.

Fourth, the immediate reaction to the evidence here is to call for wholesale legal reform. However, because improving the efficiency of the judicial system and asserting the rule of law are slow processes, it is important to incorporate those constraints into the policy design.

Finally, it is clear that improving corporate governance should be at the top of the agenda if Latin America and Mexico are to embark on a self-sustainable path of long-term development. Institution building is a critical part of the success of a market economy. The reform of those institutions that allow for a deepening of financial markets is key to ensuring business growth. Therefore, the reform of business laws and financial market regulations in Mexico and elsewhere in the region should be part of the reforms that will allow smoother integration of the economies in the FTAA region. The example of the European Community’s effort to promote institutional development in new entrant countries, such as Spain, Portugal, and Greece, is evidence of the importance of this element in assuring long and prosperous economic relations.
Bibliography


Hart, Oliver, *Different Approaches to Bankruptcy*, mimeograph (Cambridge, MA: Harvard University, November 1999).


**Appendix A: The variables**
This table describes the variables collected for the 49 countries included in our study. The first column gives the name of the variable. The second column describes the variable and gives the range of possible values. The third column provides the sources from which the variable was collected.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
<th>Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>Origin</td>
<td>Identifies the legal origin of the Company Law or Commercial Code of each country. Equals 1 if the origin is English Common Law; 2 if the origin is the French Commercial Code; and 3 if the origin is the German Commercial Code.</td>
<td>Foreign Law Encyclopedia Commercial Laws of the World.</td>
</tr>
<tr>
<td>One share - one vote</td>
<td>Equals one if the Company Law or Commercial Code of the country requires that ordinary shares carry one vote per share, and zero otherwise. Equivalently, this variable equals one when the law prohibits the existence of both multiple-voting and non-voting ordinary shares and does not allow firms to set a maximum number of votes per shareholder irrespective of the number of shares she owns, and zero otherwise.</td>
<td>Company Law or Commercial Code</td>
</tr>
<tr>
<td>Proxy by mail</td>
<td>Equals one if the Company Law or Commercial Code allows shareholders to mail their proxy vote to the firm, and zero otherwise.</td>
<td>Company Law or Commercial Code</td>
</tr>
<tr>
<td>Shares not blocked</td>
<td>Equals one if the Company Law or Commercial Code does not allow firms to require that shareholders deposit their shares prior to a General Shareholders Meeting thus preventing them from selling those shares for a number of days, and zero otherwise.</td>
<td>Company Law or Commercial Code</td>
</tr>
<tr>
<td>Cumulative voting or proportional representation</td>
<td>Equals one if the Company Law or Commercial Code allows shareholders to cast all of their votes for one candidate standing for election to the board of directors (cumulative voting) or if the Company Law or Commercial Code allows a mechanism of proportional representation in the board by which minority interests may name a proportional number of directors to the board, and zero otherwise.</td>
<td>Company Law or Commercial Code</td>
</tr>
<tr>
<td>Oppressed minorities mechanism</td>
<td>Equals one if the Company Law or Commercial Code grants minority shareholders either a judicial venue to challenge the decisions of management or of the assembly or the right to step out of the company by requiring the company to purchase their shares when they object to certain fundamental changes, such as mergers, assets dispositions and changes in the articles of incorporation. The variable equals zero otherwise. Minority shareholders are defined as those shareholders who own 10 percent of share capital or less.</td>
<td>Company Law or Commercial Code</td>
</tr>
<tr>
<td>Preemptive rights</td>
<td>Equals one when the Company Law or Commercial Code grants shareholders the first opportunity to buy new issues of stock and this right can only be waived by a shareholders’ vote, and zero otherwise.</td>
<td>Company Law or Commercial Code</td>
</tr>
<tr>
<td>%capital to call an ESM</td>
<td>It is the minimum percentage of ownership of share capital that entitles a shareholder to call for an Extraordinary Shareholders’ Meeting. It ranges from one to 33 percent.</td>
<td>Company Law or Commercial Code</td>
</tr>
<tr>
<td>Anti-director rights</td>
<td>An index aggregating the shareholder rights which we labeled as “anti-director rights.” The index is formed by adding 1 when: (1) the country allows shareholders to mail their proxy vote to the firm; (2) shareholders are not required to deposit their shares prior to the General Shareholders’ Meeting; (3) cumulative voting or proportional representation of minorities in the board of directors is allowed; (4) an oppressed minorities mechanism is in place; (5) the minimum percentage of share capital that entitles a shareholder to call for an Extraordinary Shareholders’ Meeting is less than or equal to 10 percent (the sample median); or (6) shareholders have preemptive rights that can only be waived by a shareholders’ vote. The index ranges from 0 to 6.</td>
<td>Company Law or Commercial Code</td>
</tr>
<tr>
<td>Restrictions for going into reorganization.</td>
<td>Equals one if the reorganization procedure imposes restrictions, such as creditors’ consent, to file for reorganization. It equals zero if there are no such restrictions.</td>
<td>Bankruptcy and Reorganization Laws</td>
</tr>
<tr>
<td>Variable</td>
<td>Description</td>
<td>Sources</td>
</tr>
<tr>
<td>-----------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>---------------------------------------------</td>
</tr>
<tr>
<td>No automatic stay on secured assets</td>
<td>Equals one if the reorganization procedure does not impose an automatic stay on the assets of the firm upon filing the reorganization petition. Automatic stay prevents secured creditors to gain possession of their security. It equals zero if such restriction does exist in the law.</td>
<td>Bankruptcy and Reorganization Laws</td>
</tr>
<tr>
<td>Secured creditors first</td>
<td>Equals one if secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm. Equals zero if non-secured creditors, such as the Government and workers, are given absolute priority.</td>
<td>Bankruptcy and Reorganization Laws</td>
</tr>
<tr>
<td>Management does not stay</td>
<td>Equals one when an official appointed by the court, or by the creditors, is responsible for the operation of the business during reorganization. Equivalently, this variable equals one if the debtor does not keep the administration of its property pending the resolution of the reorganization process, and zero otherwise.</td>
<td>Bankruptcy and Reorganization Laws</td>
</tr>
<tr>
<td>Creditor Rights</td>
<td>An index aggregating different creditor rights. The index is formed by adding 1 when: (1) the country imposes restrictions, such as creditors’ consent or minimum dividends to file for reorganization; (2) secured creditors are able to gain possession of their security once the reorganization petition has been approved (no automatic stay); (3) secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm; and (4) the debtor does not retain the administration of its property pending the resolution of the reorganization. The index ranges from 0 to 4.</td>
<td>Bankruptcy and Reorganization Laws</td>
</tr>
<tr>
<td>Efficiency of judicial system</td>
<td>Assessment of the “efficiency and integrity of the legal environment as it affects business, particularly foreign firms” produced by the country-risk rating agency Business International Corporation. It “may be taken to represent investors’ assessments of conditions in the country in question”. Average between 1980-1983. Scale from 0 to 10, with lower scores lower efficiency levels.</td>
<td>Business International Corporation</td>
</tr>
<tr>
<td>Rule of law</td>
<td>Assessment of the law and order tradition in the country produced by the country-risk rating agency International Country Risk (ICR). Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for less tradition for law and order.(We changed the scale from its original range going from 0 to 6).</td>
<td>International Country Risk Guide</td>
</tr>
<tr>
<td>Corruption</td>
<td>ICR’s assessment of the corruption in government. Lower scores indicate “high government officials are likely to demand special payments” and “illegal payments are generally expected throughout lower levels of government” in the form of “bribes connected with import and export licenses, exchange controls, tax assessment, policy protection, or loans”. Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for higher levels of corruption. (We changed the scale from its original range going from 0 to 6).</td>
<td>International Country Risk Guide</td>
</tr>
<tr>
<td>Accounting standards</td>
<td>Index created by examining and rating companies’ 1990 annual reports on their inclusion or omission of 90 items. These items fall into 7 categories (general information, income statements, balance sheets, funds flow statement, accounting standards, stock data and special items). A minimum of 3 companies in each country were studied. The companies represent a cross-section of various industry groups where industrial companies numbered 70 percent while financial companies represented the remaining 30 percent.</td>
<td>International Accounting and Auditing Trends, Center for International Financial Analysis &amp; Research, Inc.</td>
</tr>
<tr>
<td>Ownership, 10 largest private firms</td>
<td>The average percentage of common shares owned by the three largest shareholders in the ten largest non-financial, privately-owned domestic firms in a given country. A firm is considered privately owned if the State is not a known shareholder in it.</td>
<td>Moodys International, CIFAR, EXTEL, WorldScope, 20-Fs, Price-Waterhouse and various country sources.</td>
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<tr>
<td>Variable</td>
<td>Description</td>
<td>Sources</td>
</tr>
<tr>
<td>----------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
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</tr>
<tr>
<td>External Cap / GNP</td>
<td>The ratio of the stock market capitalization held by minorities to gross national product for 1994. The stock market capitalization held by minorities is computed as the product of the aggregate stock market capitalization and the average percentage of common shares not owned by the top three shareholders in the ten largest non-financial, privately-owned domestic firms in a given country. A firm is considered privately owned if the State is not a known shareholder in it.</td>
<td>Moodys, International, CIFAR, EXTEL, WorldScope, 20-Fs, Price Waterhouse and various country sources.</td>
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<td>Domestic Firms / Pop</td>
<td>Ratio of the number of domestic firms listed in a given country to its population (in millions) in 1994.</td>
<td>Emerging Market Factbook and World Development Report 1996.</td>
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</table>
### Table 1: Shareholder rights around the world

This table classifies countries by legal origin. Definitions for each of the variables can be found in Table 1. Panel B reports the test of means for the different legal origins.

<table>
<thead>
<tr>
<th>Country</th>
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<th>Proxy by mail</th>
<th>Shares not</th>
<th>Cumulative vote /</th>
<th>% capital to</th>
<th>Preemptive</th>
<th>Oppressed</th>
<th>Anti-director</th>
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#### English origin avg.

- **0.17**
- **0.39**
- **1.00**
- **0.28**
- **0.09**
- **0.44**
- **0.94**
- **4.00**

- **Argentina**
  - 0
  - 0
  - 0
  - 1
  - 0.05
  - 1
  - 1
  - 4
- **Belgium**
  - 0
  - 0
  - 0
  - 0
  - 0.20
  - 0
  - 0
  - 0
- **Brazil**
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  - 0
  - 1
  - 0
  - 0.05
  - 0
  - 1
  - 3
- **Chile**
  - 1
  - 0
  - 1
  - 1
  - 0.10
  - 1
  - 1
  - 5
- **Colombia**
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  - 0
  - 1
  - 1
  - 0.25
  - 1
  - 0
  - 3
- **Ecuador**
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  - 0
  - 1
  - 0
  - 0.25
  - 1
  - 0
  - 4
- **Egypt**
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  - 0
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  - 0
  - 0
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- **France**
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  - 0
  - 0
  - 0.10
  - 0
  - 1
  - 3
- **Greece**
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  - 0
  - 0
  - 0
  - 0.05
  - 1
  - 0
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- **Indonesia**
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  - 0
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  - 0.10
  - 0
  - 0
  - 2
- **Italy**
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  - 0
  - 0
  - 0
  - 0.20
  - 1
  - 0
  - 1
- **Jordan**
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  - 0
  - 1
  - 0
  - 0.25
  - 0
  - 0
  - 1
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  - 0
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  - 0
  - 1
  - 1
  - Open
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  - 1
  - 3
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  - 0.05
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- **Spain**
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  - 0
  - 0.05
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  - 1
  - 4
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  - 0
  - 1
  - 0
  - 0.10
  - 0
  - 0
  - 2
- **Uruguay**
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  - 0
  - 0
  - 0
  - 0.20
  - 1
  - 1
  - 2
- **Venezuela**
  - 0
  - 0
  - 1
  - 1
  - 0.20
  - 0
  - 0
  - 1

#### Latin American avg.

- **0.44**
- **0.00**
- **0.67**
- **0.44**
- **0.18**
- **0.78**
- **0.44**
- **2.67**

#### Rest of French origin avg.

- **0.17**
- **0.08**
- **0.50**
- **0.17**
- **0.12**
- **0.50**
- **0.17**
- **2.08**

#### French origin avg.

- **0.29**
- **0.05**
- **0.57**
- **0.29**
- **0.15**
- **0.62**
- **0.29**
- **2.33**

#### German origin avg.

- **0.33**
- **0.00**
- **0.17**
- **0.33**
- **0.05**
- **0.33**
- **0.50**
- **2.33**

#### Scandinavian origin avg.

- **0.00**
- **0.25**
- **1.00**
- **0.00**
- **0.10**
- **0.75**
- **0.00**
- **3.00**

#### Sample average

- **0.22**
- **0.18**
- **0.71**
- **0.27**
- **0.11**
- **0.53**
- **0.53**
- **2.65**

---

**Panel A: tests of means (t-statistics)**

<table>
<thead>
<tr>
<th></th>
<th>English vs. French origin</th>
<th>English origin vs. Latin</th>
<th>French vs. German origin</th>
<th>French vs. Scandinavian</th>
<th>Rest of French origin vs.</th>
</tr>
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<tbody>
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<td>-1.37 b</td>
<td>1.00 b</td>
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<td>2.00 *</td>
<td>-1.78 *</td>
<td>-3.87 *</td>
<td>-3.74 *</td>
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<td>2.64 *</td>
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<td>2.98 *</td>
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</tr>
</tbody>
</table>

a= Significant at 1% level; b= Significant at 5% level; c= Significant at 10% level; d as a percentage of votes; e as a percentage of the number of shares
Table 2: Example of Management Proposals to be voted on at Annual General Meetings in Mexico

PROPOSAL No. 1: Amend statutes
Status: Non-routine
Sponsor: Management
Opposition: None known
Proxy materials contained no information on this agenda item. Most likely it is intended to restate the Company’s capital stock in its statutes.

PROPOSAL No. 2: Approve financial statements
Status: Routine
Sponsor: Management
Opposition: None known

PROPOSAL No. 3: Set dividend
Status: Routine
Sponsor: Management
Opposition: None known
Management is asking of shareholders to approve a dividend of 0.08 pesos per share. It is not clear from materials furnished by the company whether this is full dividend or just the fourth-quarter payment.

PROPOSAL No. 4: Authorize share repurchase
Status: Routine
Sponsor: Management
Opposition: None known
Management is asking for shareholders’ authorization to repurchase its shares. It gives no reason, time limit, or maximum or minimum amount for this proposal.

PROPOSAL No. 5: Proforma Ratification of board actions, elect directors, and appoint shareholder representative
Status: Routine
Sponsor: Management
Opposition: None known
The proposal wants shareholders to approve any board candidates who might be standing for election or reelection. As is common in Mexico, the Company does not include information identifying the nominees in its proxy statement. If directors are to be elected, their names will be announced at the annual meeting.
Shareholders are asked to approve the fees for the directors, their alternates, and the stockholders examiners. The amounts are not disclosed in the proxy materials.

PROPOSAL No. 6: Appoint auditors and set their fees
Status: Routine
Sponsor: Management
Opposition: None known
Shareholders are being asked to approve the appointment of “independent” auditors and their fees.
Management has not published the name of the authors, but will announce both that and the proposed fees at the annual meeting itself.
Table 3: Creditor rights around the world
This table classifies countries by legal origin. Definitions for each variable can be found in Table 1. Panel B reports tests of means for the different legal origins.

<table>
<thead>
<tr>
<th>Country</th>
<th>Restrictions for reorganization</th>
<th>No automatic on assets</th>
<th>Secured creditor paid first</th>
<th>Management does not stay in reorganization</th>
<th>Creditor rights</th>
</tr>
</thead>
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<td>Panel A: Creditor Rights (1 = creditor protection is in the law)</td>
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<td></td>
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Panel B: Tests of means (t-statistics)

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<th>Test</th>
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<th>Significance Level</th>
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<td>English origin vs. Latin America</td>
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<td>1%</td>
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<td>French vs. German origin</td>
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<td>French vs. Scandinavian origin</td>
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</tr>
<tr>
<td>Rest of French origin vs Latin</td>
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<td>10%</td>
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</table>

a = Significant at 1% level ;  
b = Significant at 5% level ;  
c = Significant at 10% level.
Table 4: Enforcement of laws
This table classifies countries by legal origin. Definitions for each of the variables can be found in Table 1. Panel B reports the tests of means for the different legal origins.

<table>
<thead>
<tr>
<th>Country</th>
<th>Efficiency of judicial system</th>
<th>Rule of law</th>
<th>Corruption</th>
<th>Accounting standards</th>
<th>GNP per capita (US $)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel A: Means</strong></td>
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<td>10.00</td>
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**Panel B: Tests of means (t-statistics)**

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a=Significant at 1% level; b=Significant at 5% level; c=Significant at 10% level.
This table classifies countries by legal origin. Definitions for each of the variables can be found in Table 1. Panel B reports tests of means for the different legal origins.

<table>
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<tr>
<th>Country</th>
<th>Ownership Concentration</th>
<th>External Cap / GNP</th>
<th>Domestic Firms / Pop</th>
<th>IPOs / Pop</th>
<th>Debt / GNP</th>
<th>GDP growth</th>
<th>Log GNP</th>
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**Panel A: Means**

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**Panel B: Tests of Means (t-statistics)**

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a=Significant at 1% level;  b=Significant at 5% level;  c=Significant at 10% level.
Table 6. Statistics on the Mexican Stock Exchange

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<tr>
<td>Total value traded/Market Cap.</td>
<td>0.479</td>
<td>0.379</td>
<td>0.404</td>
<td>0.336</td>
<td>0.369</td>
<td>0.226</td>
<td>0.328</td>
<td>0.311</td>
</tr>
<tr>
<td>Number of listed firms</td>
<td>209</td>
<td>185</td>
<td>193</td>
<td>198</td>
<td>195</td>
<td>190</td>
<td>177</td>
<td>171</td>
</tr>
<tr>
<td>Number of de-listed firms</td>
<td>3</td>
<td>6</td>
<td>2</td>
<td>1</td>
<td>4</td>
<td>7</td>
<td>15</td>
<td>7</td>
</tr>
<tr>
<td>Initial public offerings</td>
<td>13</td>
<td>1</td>
<td>10</td>
<td>6</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>1</td>
</tr>
</tbody>
</table>

Table 7. Firm Compliance with the Code of Best Practices in Mexico

- **SUBMITTED**: 178 Companies
- **MISSING**: 13 Companies
- **DEFERMENT**: 15 Companies
- **SUSPENDED**: 33 Companies

The companies that requested a deferment have already submitted the requested information.
Table 8. Stock Market Parameters in 2001 in the main Latin Markets

<table>
<thead>
<tr>
<th>Country</th>
<th>% of Active Shares in the market</th>
<th>Volume Decline compared to 2000</th>
<th>Transaction Costs</th>
<th>Ranking (name) in ADR Activity in US</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>20%</td>
<td>65%</td>
<td>9 cents</td>
<td>9th. (YPF)</td>
</tr>
<tr>
<td>Brazil</td>
<td>13%</td>
<td>40%</td>
<td>10-11 cents</td>
<td>3rd. (Telebras)</td>
</tr>
<tr>
<td>Mexico</td>
<td>23%</td>
<td>50%</td>
<td>8 cents</td>
<td>8th. (Telmex)</td>
</tr>
</tbody>
</table>