THE IMPORTANCE OF THE LAW MATTERS THESIS

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Abstract

The 'law matters' thesis is undisputed, keenly preserved and persuasively argued in the legal literature. For something to matter, relevance or importance depends on the audience - the readers or users of that material. This research critically examines the law matters thesis, considering to whom it matters and why. This research also critiques the law matters thesis from a perspective largely beyond the mainstream law journals and yields perspectives often overlooked in the law literature.

'Law matters' advocates argue that the existence of strong investor protection results in observed economic growth and development of capital markets. While one might conclude there is a strong correlation between legal culture and financial capital market development in legal research, non-legal research provides counter-evidence that legal culture alone does not determine financial market growth in East Asia.

Keywords: Law matters, International Legal Structure, Minority Interests

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Introduction

Law matters[1] proponents conclude that minority shareholder protection in a corporate governance regime directly influences continued investment and capital market development. This single aspect of corporate governance is argued to be the primary focus of any reform in East-Asian countries and is considered to be essential to the development of capital markets in the East-Asian region[2]. To establish the validity of this proposition, we must ask does the protection of minority interest matter in capital market development in East Asia?

This paper provides evidence that that the 'law matters' thesis particularly in relation to minority interests is overstated[3] in legal research. In drawing this conclusion, a number of subsidiary issues have been analysed: To whom does the law matter? What evidence is presented to support the 'law matters' proposition, and are the research conclusions value-judgement free? What aspects of the law are important to capital market development? Should the Law have a bearing on the investment decision? Are there other factors other than Law that promotes and stimulates a safe investment climate?

Lawyers shall always argue that 'law matters'[4]. Legal research stresses the importance of the legal discipline to the development of financial markets. The law matters debate can be distilled into three research avenues that cross the disciplinary divide in Economics, Finance and Law namely: (1) the significance of safeguarding minority interests in capital market development; (2) an investigation of other factors also responsible for enhancing capital markets; and (3)

[1] A literal interpretation is that 'matter' is an 'affair or situation under consideration', 'the reason for …', 'material for thought or expression of significance or importance'. The law is defined as 'a rule [(or body of rules)], enacted or customary in a community and recognised as enjoining or prohibiting certain actions and enforced by the imposition of penalties", collectively defining 'a social system'. In the context of this research, the influence of the law is significant and material. The law is distinguished from enforceability, where the latter could mean 'imposed', 'compelled observance' being derived from the French Latin roots 'fortis' meaning 'strong'. Definitions derived from The Australian Concise Oxford Dictionary 1987 7th edition, Oxford University Press, Melbourne, Victoria, Reader's Digest, 2001, Word Power Dictionary, London, U.K and The Reader's Digest Oxford Complete Wordfinder, S. Tulloch (Ed.), London, UK.

[2] Gordon Walker, 'Corporate Governance in East Asia: The Policy Rationale for Reform' (2004) La Trobe University Working Paper, April; Florencio Lopez-de-Silanes, 'A Survey of Securities Laws and Enforcement' (2003) Yale University Working Paper.

[3] Overstatement seems to be a rational and reasonable viewpoint as it cannot be said that law has no effect, but it appears at least from the debate that the legal researchers make a much stronger claim concerning the importance of the law than the finance researchers.

[4] It is in the interests of lawyers to argue the case that the law is relevant [see Maynard, T.H., March 2002, "Law Matters, Lawyers Matter", Loyola-LA Public Law Research Paper No 2002-4 at http://ssrn.com/abstract=303570.

issues related to the relevance of 'transplanting' US Law to East Asian and other international settings versus allowing diversity in legal culture and structure[5].

Minority Interests and Capital Market Development

'Law matters' researchers cite a body of empirical Finance literature to support their argument. They have seized these empirical findings, implied a causal relationship where legally established investor protection exerts a strong influence on financial market and economic development, and concluded in favour of the 'law matters' thesis. An example of this follows:

"[t]he principal insights … flow from the work of Rafael La Porta and colleagues and other colleagues working in this vein – the "law matters" thesis … legal corporate governance measures are much more important than previously thought. In short, the legal approach to corporate governance holds that the key mechanism is the protection of outside investors through the legal system, meaning both laws and their enforcement. Investor protection is important because of potential and actual expropriation of minority shareholders and creditors by controlling shareholders. There is good evidence of expropriation of minority shareholders in the East Asia. Hence legal rules and their enforcement are crucial. This is because, in some countries, enforcement cannot be assumed. … *investor protection has consequences for the particular country. First, investor protection has implications for ownership structures;* countries with poor investor protection typically exhibit more concentrated control of firms than do countries with good investor protection. *… investor protection encourages the development of financial markets. … investor protection influences the real economy"*[6]

Walker's argument above could however be reversed. Country specific socio-economic characteristics such as GDP per capita, the level of government intervention and corruption as well as family dominated ownership structures in E-Asia may be influential on the level of investor protection. If few minority interests exist or if these minorities constitute overseas institutional investors able to protect themselves - is there a need to provide this form of protection?

Contribution of the La Portaetal research

The La Porta et. al. studies are broad in coverage. They collectively analyse political, economic and environmental systems and offer country-based and legal-origin based comparisons in diverse areas as: government ownership of banks[7]; agency problems and dividend policy[8]; corporate ownership[9]; investor protection[10]; labour markets[11]; comparative economics[12]; legal determinants of external finance[13]; expropriation via tunnelling[14] and the effect of securities law[15] and their enforcement[16].

A careful read of the body of La Porta et. al. research reveals that the law is one of many influences that shape economic development. The 'law matters' perspective was first raised in their 1998 'Law and Finance' paper. In this paper, they establish that differences in the nature and effectiveness of a country's financial system depend upon investor protection. These protections relate specifically to expropriation by insiders as captured in the legal origin and enforcement quality proxies. In a related paper first released in 1997 examining the determinants of external finance, the same authors examined factors affecting the size of capital markets, the number of listed firms on the stock market, the number of new listings. Larger equity markets and higher shareholder rights were more prevalent in common law countries relative to civil law countries. Countries with a greater number of listings

[5] This last point is only briefly made but accounts for many legal references. Being sociologically based it is both controversial and filled with value judgements. It is important to this writing in so much that the complex issues provide a 'frame' in which the rest of the analysis follows and an expression of these perspectives is a reflection of existent contemporary legal writing that either encourages or shuns the extent to which the role of localised custom and societal influences should influence historical legal development

[6] Gordon Walker (2004) taken from the abstract.

[7] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer 'Government Ownership of Banks' (2002) 57(1) February Journal of Finance 265-301.

[8] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer 'Agency Problems and Dividend Policies around the World' (2000) 55(1) February Journal of Finance 1-33.

[9] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer 'Corporate Ownership around the World' (1999) 54(2) April Journal of Finance 471-517

[10] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 2003, 'Investor Protection: Origins Consequences, Reform', (1999), December NBER Working Paper 7428, June at http://www.nber.org/papers/w7428.

[11] Juan Botero, Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer 'The Regulation of Labor', (2003), June NBER Working Paper 9756 at http://www.nber.org/papers/w9756.

[12] Botero, J., Djankov, S., La Porta, R., Florencio Lopez-de-Silanes, Andrei Shleifer, 2003, "The Regulation of Labor", NBER Working Paper 9756, June at http://www.nber.org/papers/w9756.

[13] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny "Legal Determinants of External Finance' (1997) June NBER Working Paper 5879 at http://www.nber.org/papers/w9756.

[14] Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer 'Tunnelling', (2000) February June NBER Working Paper 7523 at http://www.nber.org/papers/w7523.

[15] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer 'What works in Securities Laws?', (2003), July NBER Working Paper 9882 at http://www.nber.org/papers/w9882.

[16] Florencio Lopez-de-Silanes, 'A Survey of Securities Laws and Enforcement' (2003) Yale University Working Paper, October.

and initial public offers also exhibited better enforcement proxied by the 'rule of law'. Enforcement is also a topic re-visited by Lopez-de-Salines where the most critical aspect of the regulatory reform was seen to be laws that specifically encourage private enforcement of public rules and laws that are designed to facilitate enforcement and court procedures.

Finally, in a paper specifically examining insider expropriation via tunnelling, Johnson, La Porta, Lopez-de-Salines and Shleifer advocate that reform should focus on building a stronger and more effective judiciary as "the application of general principles such as the duty of care and the duty of loyalty by courts may influence how firms in different countries organize and finance themselves"[1718].

Despite this evidence, it is difficult to conclude with certainty that the principal factor that drives capital market development is the protection of minority interests. The empirical evidence adopted to support the 'law matters' thesis is subject to the usual caveats associated with empirical research validity. The conclusions drawn in these papers are sample specific and findings are highly dependent on how proxies are constructed, the ability for the researchers to control for known influences, treatment of outliers, treatment of missing values and endogeneity and should be interpreted in context.

Possibly the most problematic issue facing the law matters researchers is the question of how legal influence should be measured? It could be measured: quantitatively (as a dummy indicator indicating the presence or absence of the legal factor or as an amalgam ranking or weighted average of a number of legal factors) or qualitatively (in terms of its perceived importance). How researchers choose to measure variables has an impact on the research findings. Each measure admits varying degrees of subjectivity and also depends on whether the researcher uses a narrow or wide interpretation of the Law (with or without enforceability proxies) [19]. Economists make a clear distinction between 'enforceability' and the Law itself, whereas these terms are often integrated in the minds of legal researchers.

"The legal approach to corporate governance holds that the key mechanism is the protection of outside investors – whether shareholders or creditors – through the legal system, meaning both *laws* and their *enforcement.* Although reputations and bubbles can help raise funds, variations in *law* and its *enforcement* are central to understanding why firms raise more funds in some countries than in others. … For example, contract law deals with privately negotiated arrangements, whereas company, bankruptcy and securities laws specifically describe some of the rights of corporate insiders and outside investors. These *laws*, and the quality of their *enforcement* by regulators and courts, are essential elements of corporate governance and finance".

The relationship between the protection of minority interests and capital market development can also be moderated by other influences. For example, the home-country legal protection of minority shareholders diminishes in importance when firms deliberately improve internal firm specific corporate governance mechanisms or gain access to international capital markets. This implies that the firm can deliberately chose to privately resolve harmful and weaker country-level controls. This substitution effect is a partial explanation for variation in corporate governance practise within a country. The extent to which firms will choose to do this will depend on cost-benefit trade-off. Countries with poor economic and financial development face less incentive to regulate and improve governance mechanisms when the costs of implementation are high[20] compared with countries with large capital markets and more global reach. Possible interrelatedness and endogeneity of variables entering the econometric model will limit the inferences one can make[21].

[17] Simon Johnson, Rafael La Porta, Florencio Lopez-de-Salines and Andrei Shleifer, 'Tunnelling' (2000), NBER Working Paper 7523 at http://www.nber.org/papers/w7523 at 12.

[18] The concept of fiduciary duty was not enshrined in Chinese corporate law until recently, refer to the Economist [Electronic Version] "In Praise of Rules" (2001) April 5; Schipani and Junhai 'Corporate Governance in China: Now and Then at www.iolaw.org.cn/en1/art5.asp. Since September 2001, a Code of Corporate Governance for Listed Companies has been introduced in the PRC. Refer to Violet Xing 'Corporate Governance in People's Republic of China : A New Code for Listed Companies", in Comparative Corporate Governance, J.H. Farrar (Ed.), Bond University Press, Gold Coast at 353-359. Chinese companies need to also accommodate government and worker interests, but this is proving problematic to administer as the notion of property rights as a legal concept is not well developed in PRC.

[19] In the 1997 study, a single variable for the "rule of law" was adopted from the International Country Risk Guide. This was an "assessment of the law and order tradition in the country consisting of an average of the months of April and October of the monthly index from 1982-1995" (at Table 1). In other later articles from La Porta et al 1998 onwards they develop an more comprehensive index of equally weighted attributes which comprise of a numerical score from zero to six which indicates the cumulation of factors present when (1) shareholder proxy votes can be mailed (2) shareholders are not required to deposit their shares prior to an AGM, (3) cumulative voting or proportional representation of minorities on the board of directors is allowed, (4) an oppressed minorities mechanism is in place; (5) if a shareholder can call an EGM with less than 10% of the share capital or (6) when pre-emptive rights can only be waived at a shareholders meeting.

[20] Corporations, like individuals face is a self-fulfilling vicious circle of poverty, as lower investor confidence increases the cost of capital.

[21] This aspect is explicitly mentioned: "As in many other studies in this area, the causal effect of securities laws on financial development cannot be established with certainty"(2003, p15)

One aspect of the La Porta et al 1997 paper which is particularly damaging to the 'law matters' thesis is an open declaration by the authors that:

"the correlation between the rule of law and GDP per capital is .87, we do not include GDP capita as a control. Doing so not have much effect on the coefficients on legal rule variables, *but does eliminate the significance of the rule of law"* (1997 p.12).

Intuitively, one would expect that the development of financial markets to be rationally related to the level of GDP per capita, as investors must earn sufficient funds beyond current consumption to invest. We should interpret empirical results cautiously as corporate governance data is expensive to collect, compile and compare due to language barriers and different disclosure regimes. Corporate governance data is more likely to be subjectively rated and due to resource limitations, there is a higher probability that a firm will feature in a corporate governance database if it is large, it belongs in an industry group which is extensively monitored by the global investment community, is listed on a more developed stock exchange or is incorporated in a country that allows international financial intermediation.

A further consideration is the nature of the developmental social and economic history of a country or a region. Isolationalism, despotism and a feudal-familia collectivism have largely shaped East Asian historical development[22]. Hobson advances a bold, well supported and articulate view that historical accounts of the rise of Western civilisation are 'positively' framed and described in an ethnocentrically biased manner. He argues that Western imperialism and appropriation of Eastern resources including markets, land and labour have diminished the importance of Eastern culture and influence on world economic development. To advance his thesis, Hobson cites the importance of economic thinkers such as Max Weber who posed the question "what was it about the West that made its path to modern capitalism inevitable? And why was the East predestined for economic backwardness?" Weber's response to these questions is based on the following assumed foundations that:

"the West was blessed with a unique set of rational institutions which were both liberal and growth permissive. The growth-permissive factors are striking for their presence in the West and for their absence in the East". [23]

The existence of a 'unified civilisation with an absence of social power between groups and institutions' and a fusion of public and private realms has shaped E-Asia economic, social, political, cultural and legal thinking. The historical importance placed upon economics and trade development in the E-Asian region suggests differentiated ethnocentric biases keenly reflected in the regional social codes and norms, which are in turn reflected in inherent legal structures. Indeed, it is worth considering whether the perceived importance of legal structure may be overstated in relation to economic and capital market development, as legal structure may act more as an observed proxy for societal effects than in and of itself.

Other Factors

Minority interest protection is not the only factor influencing capital market development. In their external finance study, La Porta et. al suggest that other factors affect stock market size (measured by market capitalisation) such as *historical gross domestic product (GDP), real gross national product and GDP per capita.* Similarly, in their paper concerning government ownership of banks, they show that higher *government ownership of banks* retards financial development and leads to lower productivity growth. Countries with high government ownership are also found to be related to lower income per capital, underdeveloped financial markets, property right protection and largely inefficient and controlling governments. *Institutions* are also found to exert a 'profound influence' on economic development as institutions "choose political leaders, to secure property rights, to redistribute wealth, to resolve disputes, to govern firms, to allocate credit and so on…institutions differ tremendously and systematically among countries, with significant consequences for economic performance"[24]. Other authors have argued that the degree of *international financial integration* matters. As corporations have grown, the day-to-day operational decisions have been entrusted to a small group of managers, rather than the entire group of owners. This continued growth in the 20th century has overstepped traditional country-defined geographical boundaries and individual legal jurisdictions (for example, the multinational firm, the creation of supra-jurisdictions such as the European Union, and, other preferential trading conditions such as free-trade agreements), integrated global consumer and financial markets. Further, the explosion in international funds management operations constantly require new markets and new investment products to channel the life-savings

[22] See John Hobson (2004) The Eastern Origins of Western Civilisation Cambridge University Press.
[23] Ibid p15.

[24] Simeon Djankov, Edward Galeser, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'The New Comparative Economics' (2003), NBER Working Paper 9608, at http://www.nber.org/papers/w9608,1. Institutions might also create inefficiencies as diverse regulatory structures may lead to 'porosity' (as indicted by Mark Roe) or may lead to 'lock-in' effects (as suggested by Gregory Jackson) where regulators are 'captured' (see Richard Posner).

of superannuants from developing countries. Such investors currently enjoy high levels of investor protection in home jurisdictions, that it would be essential for these investors to impose supplementary forms of monitoring and bonding or knowingly bear additional investment risk. The level of integration is itself dependent upon high levels of real per capital GDP, education, the development of the banking sector and stock market, law and order tradition and low levels of government corruption[25]. The securities law paper suggests the importance of securities law is positively associated with the size of the stock market. This finding that legislation matters is opposite to the traditional economic view[26] that legal regulation is unnecessary, and offers the view that securities law serves to resolve disputes and contract costs[27]. Finally, an historical link between financial market prices/ returns and *population age structure* has been proposed[28].

There is also an associated body of literature suggesting that real economic growth is dependent upon financial development[29] and better information disclosure[30]. Lopez-de-Salines (2003, p7-8) question the role of mandating disclosure citing that prior research by Easterbrook (1984) and Macey (1994):

"refute[s] the argument that securities regulation is necessary to protect minority interests by increasing the amount of truthful information in the market. The existence of a large pool of sophisticated or "educated" investors in the market guarantees that all available information is priced into the market. Therefore uneducated investors are not in any risk of being exploited, on the contrary they benefit from the research of educated investors without paying any of the costs".

Recent research has also highlighted a strong statistical association between corporate governance factors tracked by institutional investors and changes in firm value.[31] From a set of 24 key governance parameters, this research reveals that entrenchment of managerial actions via requirement for staggered boards, limits to by-law amendments, supermajority voting requirements for changes in charters and mergers as well as provisions for poison pills and golden parachutes are negatively related to changes in shareholder value[32].

The findings of Edison, Levine, Ricci and Slok suggest that international financial integration substitutes for local rule of Law and government integrity. They state that international financial integration is positively related with [economic] growth but the "positive growth-effects diminish as adherence to the rule of law and the integrity of government increase" (p.22).

Comparative law research recognises that corporate governance regimes are "an interlocking combination of corporate (or company) law, capital market regulation, and labor relations law into a nationally distinctive and self reinforcing tripartite legal structure that allocates and orders the decision-making powers and processes within the corporation"[33]. If only it could be this simple. Yet, this tripartite list is not a panacea for capital market development as the Law itself does not completely resolve uncertainty surrounding investor confidence, capital market and economic development. To achieve this, the Law must be enforced as "[l]aws that stay on the books and are not enforced are tantamount to having no regulation at all" (Lopez-de-Salines 2003, p29).

There is evidence that minority protection enhances the capital market and that strong capital markets fuel economic growth. The empirical significance of this relationship depends on how it is measured and the nature of the other factors that have been controlled for in the research method. We have also established in this discussion that a multitude of other factors exist that support financial development and economic growth. The strength of the association between the Law and capital market development depends upon: (1) whether the 'Law' is interpreted with a wide (including accounting disclosures) or narrow definition; (2) the extent to which sophisticated investors from developed countries can influence the investment environment via self-monitoring and enforcement; (3) reputation effects via the listing of a company's shares in more than one legal jurisdiction; and, (4) the historical importance of monitoring and bonding mechanisms in that legal jurisdiction.

[25] Hali Edison, Ross Levine, Luca Ricci and Torsten Slok 'International Financial Integration and Economic Growth' (2002), NBER Working Paper 9164 at http://www.nber.org/papers/w9164.

[26] George Stigler, 'Public Regulation of the Securities Market" (1964) 37 Journal of Business, 117-142 argued that contract enforceability is all that is required and capital market regulation is unnecessary.

[27] Rafael La Porta, Florencio Lopez-de-Salines and Andrei Shleifer 'What Works in Securities Laws?' (2003) at 8.

[28] James Poterba, 'The Impact of Population Aging on Financial Markets' (2004) NBER Working Paper 10851 at http://www.nber.org/papers/w10851.

[29] Jeffrey Wurgler, 'Financial Markets and the Allocation of Capital', (2000) 58 Journal of Financial Economics 187-214.

[30] Randell Morck, Bernard Young and Wayne Yu, 'The Information Content of Stock Markets: Why Do Emerging Markets have Synchronous Price Movements? (2000) 58 Journal of Financial Economics, 215-260.

[31] Lucien Bebchuk, Alma Cohen and Allen Ferrell, 'What Matters in Corporate Governance?' (2004) Harvard Law School Discussion Paper 491.

[32] For a detailed description of these governance parameters refer to Bebchuk, Cohen and Ferrell as well as Morris Danielson and Jonathan Karpoff, 'On the Uses of Corporate Governance Provisions' (1998) 4 Journal of Corporate Finance 347-371.

[33] John Cioffi, 'Review Essay: State of the Art Review on Comparative Corporate Govenance: The State of the Art and Emerging Research' (2000) American Journal of Comparative Law, 48, Summer, 501.

Diversity in International Legal Structure

When we examine East Asian countries we see variations in legal and corporate governance structures (including overall the governance environment as well as adopted voluntary firm-specific governance mechanisms) as well as the size and sophistication of the financial markets[34]. The extent to which each Asian country has been affected by the Asian crisis has also varied[35]. Each country's economics, government attitude and Law is firmly tied to its people and their beliefs and culture. Each society has a traditional culture which is highly distinctive, honoured and historically path dependent. Legal culture - a term used to describe local and clustered ('glocalised') attitudes, opinions and values in relation to the Law - also reflects these underlying social traditions.[36] This diversity is one reason why corporate governance systems of the world are less likely to converge to a single governance structure[37].

It is not surprising then that East Asian firms are structured differently from those in western cultures. The typical Asian firm is smaller and is family controlled holding highly concentrated and most often majority shareholding stakes. There is an extensive use of business networks (characterised by 'guanxi'), pyramidal ownership[38] and cross shareholdings[39].[40] Morck and Yeung[41] argue that the importance of minority interests is less important in SE Asia relative to other western cultures. This alone would suggest that perhaps a strong focus on minority interest protection might be misplaced. Personal connections are highly valued and these relationships are critically important as 'know-who is as important as know how'[42]. There appears to be far less transparency in accounting disclosure in East Asian countries. This is partly due to the pyramidal structure, but the channels by which financial information flows via the media are also problematic as they are not entirely independent and highly influential[43].

Recent research in E-Asia reveals that agency conflicts arising between minority shareholders and owners can be alleviated via the adoption of large and reputable 'Big 5' auditors to act as monitors and ensure effective investor protection[44] and also via the adoption of law concerning executive and director duty of care[45]. If there has been a well defined and a long-term legacy of formal Accounting-based regulation (perhaps adopted from British colonial days) which is self-monitored and administered by the Accounting profession, agency costs are lessened and strengthened via the existing Accounting stewardship requirement. Similarly, if certain types of shareholders such as private block holders can bond and monitor the agents in such a way that their actions are representative of all

[34] See Leora Klapper and Inessa Love 'Corporate Governance, Investor Protection and Performance in Emerging Markets' (2004) 10 Journal of Corporate Finance 703-728.

[35] Many explanations have been given for the Asian crisis, a large proportion of these blame high levels of bank finance, tight government controls on banks and the fickleness of international institutional investors. Protection of minority interests alone is not a panacea towards the development of capital markets in E-Asia. William Daniel 'Corporate Governance in Indonesian Listed Companies: A Problem of Legal Transplant' (2003) in Comparative Corporate Governance, J.H. Farrar (Ed.), Bond University Press, Gold Coast, argues that liberalisation of this market and bank regulatory reform created unusually high levels of investor uncertainty and this was responsible for the retraction of international investment funds and a collapse of the currency.

[36] Chaihark Hahm, 'Law, Culture and the Politics of Confusianism' (2003) 16 Columbia Journal of Asian Law 253.

[37] With increased international financial integration, regulatory focus has been on the unification of the Law in a competitive global market place. U.S. regulation is commonly regarded as a quasi-international standard, yet it is appropriate and relevant to culturally diverse East Asian communities? This issue is discussed in detail by John Farrar (2005) in 'Comparative Corporate Governance Systems: An Overview', ch 34 and 'The Globalisation of Corporate Governance' ch 35.

[38] A layered corporate structure which reduces transparency and also serves to reduce the voting rights of less powerful shareholders. For further details refer to Kamini Singam, 'Corporate Governance in Malaysia', in Comparative Corporate Governance, J.H. Farrar (Ed.), Bond University Press, Gold Coast at 294-7.

[39] Stijn Claessens, Simeon Djankov and Larry Lang, 'The Separation of Ownership and Control in East Asian Corporations' (2000) 58 Journal of Financial Economics 81-112; Joseph Fan and T.J. Wong 'Corporate Ownership Structure and the Informativeness of Accounting Earnings in East Asia' (2002) 33 Journal of Accounting and Economics 401-425;

[40] Walker commented [in lecture 30/9/2004] that many of the East-Asian countries of British common law background such as Malaysia, Singapore and Hong Kong have largely adopted practices similar to Australia. Recent changes in both the Corporations Law and ASX Listing Rules have 'softened' in a practical sense, the role of regulators such as the ASX and the ASIC. It is now the case that prevailing regulations result in greater regulatory interpretation (compared with checklist requirements predating the 1990 Companies Code and pre-amalgamation of Australian Stock Exchange Listing Rules) and less direct monitoring by regulators, implying greater acceptance of market forces and potential capital market 'failure'.

[41] Randall Morck and Bernard Yeung 'Special Issues Relating to Corporate Governance and Family Control' (undated) Global Corporate Governance Forum, Washington DC.

[42] Quote from M. Backman 'Asian Eclipse – Exposing the Dark Side of Business in Asia (2001) Revised Edition 2 included in Kamini Singam, 'Corporate Governance in Malaysia', in Comparative Corporate Governance (2003) J.H. Farrar (Ed.), Bond University Press, Gold Coast, Queensland at 295.

[43] Singam (2003) at 314.

[44] Joseph Fan and T.J. Wong, "Do External Auditors Perform a Corporate Governance Role in Emerging Markets? Evidence from East Asia, (January 2002), William Davidson Institute Working Paper No. 400 at http://ssrn.com/abstract=290290.

[45] Governance in the Peoples Republic of China is reviewed in Cindy Schipani and Liu Junhai 'Corporate Governance in China: Then and Now', at http://iolaw.org.cn/en1/art5.asp. These authors acknowledge that the PRC does not reflect the concept of duty and responsibility of directors or shareholder derivative suits in the Chinese Corporate Law. Apparently shareholder derivative actions are possible but rarely heard by Chinese courts.

shareholders, including atomistic ones[46], investor confidence to invest in equity markets is maintained.

Significant information asymmetry exists between inside management and owners in East Asian markets and the quality of information disclosed is lower than developing countries [see Ball, Robin and Wu (2003)]. Lower quality accounting disclosures reduces the effectiveness and accuracy of external monitors.

La Porta et al (2000) argue that the effectiveness of governance mechanisms is tested when economic conditions for investment deteriorate. This means that the extent of minority shareholder expropriation is expected to be negatively correlated with the firm's opportunities to invest. Chen, Chen and Wei suggest a way of looking at the viability of governance structures is to measure the relationship between the cost of equity capital, the level of accounting disclosure and other governance factors. Using an independently survey of corporate governance practice in Asian Emerging markets by Credit Lyonnais covering approximately 500 firms from 9 countries they examined: disclosure transparency, management discipline, independence, accountability, responsibility, fairness and social awareness. They find these measures are significantly and negatively related to the book to market ratio and the cost of equity capital. The authors cautiously suggests that "given the significant correlations between risk-relevant firm characteristics and disclosure as well as corporate governance, the inference drawn from simple correlations may be misleading" (p. 20). These authors determine that mandating information disclosure may not be effective in East-Asia. This is conjectured as the information quality and external governance mechanisms (such as shareholder litigation and corporate control mechanisms) are weak due to less effective enforcement and highly concentrated ownership.

The highly concentrated ownership structure of the SE Asian firm leads to a rejection of the owner-manager separated agency paradigm of Jensen and Meckling (1976). A more likely framework to describe SE Asian companies is stakeholder theory advocated by Hill and Jones (1992). Countries with significant government influence, greater family controlled businesses and less reliance on a market economy may have lower levels of investor protection. The family structure within the firm may be able to resolve agency issues internally and ensure sufficient information provision. These autocracies are highly influential across the business, social and political environs and as such respond differently:

"when one family member suffers, others come to his aid. Such an act is motivated by a sense of family obligation, responsibility and honor which can be quite different from the notions of legal obligation or legal duty"[47].

In many less developed countries, the extent of government corruption and expropriation is so high that it is often a better proposition to trust members of an extended family than the government.

If aspects of the local stock markets were problematic large East Asian firms could potentially gain access to international capital markets by cross-listing[48]. The firms would signal their governance quality and are required to legally adhere to differential listing and international reporting requirements. This would 'neutralise' the impact of local customs and legal culture[49].

So can the East Asian region be reformed? Johnson, La Porta, Lopez-de-Silanes and Shleifer suggest that legal reform should reduce aim to reduce looting as countries that have legal structures prohibiting this activity experienced 'milder' economic crises in the period 1997-1998. The type of looting they refer to relates to fraud via self-dealing by insiders as well as dilutive actions which reduce the relative voting rights of outside shareholders. What is required to reform these countries is not the setting of the rule 'thou shall not loot', but largely operational reform relating to how the judiciary interprets the law and sets the legal standard of proof for prosecution.

Mary Hiscock takes a different perspective and essentially argues that human behaviour set via traditional values and norms is less likely to be shifted via law reform. She is quoted in Tabalujan (at 155-6) as saying:

"law is a plant that grows out of the roots of its people, and is an important way of educating people to change. If what is [sought] is a ready-made law, it can be bought 'off the peg' from any consultant. But all there is then is a law. People still do the same things they always did. Nothing changes. That is the lesson of Asian history".

Further, acceptance of any transplanted law is essential for the Law to be effective.

[46] See Michael Wilbin and Li-Anne Woo, 'Agency Resolution Mechanisms' (2003), UNSW Working Paper.

[47] Tabalujan (2003) at 153.

[48] Brian Henderson, Narasimhan Jegadeesh and Michael Weisbach 'World Markets for Raising New Capital' (2003) University of Illinois working paper, December reveal that debt markets are more internationally integrated than equity markets "despite the fact that cross-border issues of debt do not offer many of the advantages of cross-listings of equity" at 8. This may be due to higher levels of creditor protection and lower costs of information disclosure as typically debt issuers do not have to fulfil onerous disclosures in foreign markets.

[49] William Reese and Michael Weisbach, 'Protection of Minority Shareholder Interests, Cross-listings in the United States, and Subsequently Equity Offerings' (2000) University of Illinois Working Paper, January, show that firms from French civil law jurisdictions and countries with fewer shareholder protections are more likely to list in the U.S. and be subject to securities law and GAAP of the US.

"In developing countries of East Asia today there are a few – not many – people who … have seen the light. The light in question is not necessarily that of democracy or individual freedom as such, at least not yet. Instead, it is that of protecting the rights of individuals and minorities in one particular area of life: business. Sustainable economic growth requires efficient capital markets, and today these markets are global. They consist of a myriad of shareholders and creditors who each take small stakes in many different companies. If investors are confident that their rights are well protected, they open their wallets; if they fear that the majority shareholders, managers or governments might fleece them, they hold back. … The history of capitalism is strewn with episodes of excessive enthusiasm followed by excessive caution, and East Asia has recently added another chapter. For a few years, it looked as though the entire region might vault from third world to first in a few decades … Mesmerised by this 'Asian miracle', western investors poured their money into the region. They knew its legal systems were immature and its companies opaque, but as in all bubbles, greed triumphed over caution"[50].

It is entirely possible that despite all of the preceding discussion and corporate governance recommendations, the cultural divide is so different between East Asian countries and western corporate governance practice, that attempts of imperialistic legal reform falls on deaf ears[51].

Conclusion

Existing multi-disciplinary evidence suggests the prospect of downgrading the significance of the law and legal structure upon corporate governance structures and financial market development in East Asia. Legal research is particularly supportive of the importance of law in this area, however the importance of the legal proxy diminishes when one examines closely a wider set of comparative literature drawn from Economics, Finance and sociology. Perhaps, like Hobson's conjectures, this review is biased at the source[52], as research has been drawn exclusively English language citations and is more likely to reflect western ideals than eastern approaches. What is however apparent is that the relationship between the Law and financial market development is complex and its perceived importance depends greatly upon the writer's or reader's personal perspective.

While the protection of minority interests is a highly correlated factor with capital market development, it does not appear to be the most critical element in East Asian corporate governance reform. There is a positive relationship between financial market development and historical GDP, real gross product, GDP per capita and the level of international financial integration, and an inverse relationship with the level of government ownership of banks.

The performance of the stock market also depends on the productive capacity of real assets and demographics reflected in the age structure of the population. That 'law matters' as a basic statement seems irrefutable, but how much it matters indeed, is a matter of much conjecture.

[50] The Economist, 'In Praise of Rules' [Electronic Version] (2001), at www.economist.com/surveys/PrinterFriendly.cfm?Story_ID=559389.

[51] In 'The Inevitable Instability of American Corporate Governance' (2004) September Harvard Law School Discussion Paper 493, Mark Roe investigates the structural problems of a system of laws that supposedly is better than that prevailing in E-Asia. He argues that the regulatory system is placed under pressure, with greater decentralisation there is regulatory 'porosity'. This occurs when co-ordinated regulation breaks down and there is a clouded view of who is responsible for what in the regulatory system, which results in failed monitoring. This together with extensive lobby groups is problematic.

[52] Research written in foreign languages which specifically deals with local governance issues is beyond the limits of this writer.

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