Aldo Musacchio

Laws versus Contracts: Shareholder Protections and Ownership Concentration in Brazil, 1890–1950

This article examines some of the institutional conditions that facilitated the development of equity markets in Brazil. A critical factor was the addition to corporate bylaws of protections for investors, which enabled relatively large corporations in Brazil to attract investors in large numbers. By availing themselves of this strategy, the firms generated a relatively low concentration of ownership before 1910. Archival evidence, such as company statutes and shareholder lists, reveals that the addition of voting rights to their bylaws, particularly maximum-vote provisions and graduated voting scales (which stipulated that less-than-proportional votes increase in parallel with shareholdings), allowed many Brazilian corporations to balance the relative voting power of their small and large investors. In companies that made such arrangements, the concentration of ownership and control was sharply lower than in the average company. Judging by the Brazilian companies examined for this article, it also appears that the concentration of control was significantly lower before 1910 than it is today.

The early development of large multidivisional corporations in Latin America required more than capable managers, new technologies, and large markets. In order to facilitate the rise of these companies, entrepreneurs had to build a capital market that would attract investors to buy either debt or equity. I will examine how the investor protections

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written into company bylaws enabled corporations in Brazil to attract investors in large numbers, generating a relatively low concentration of ownership and control in large firms before 1910.

My central thesis is that the development of equity markets at the turn of the twentieth century in Brazil required companies and their founders to be willing to offer protections to outside shareholders, especially small investors, in order to encourage them to buy equity. When these protections were extended, they reduced agency costs and guaranteed small investors certain protections against possible abuses by large investors or other insiders. These shareholder protections are an important consideration because, according to the theory of the firm as stated by, for example, Michael C. Jensen and William H. Meckling, outside investors risk extraction or expropriation of value by a company’s managers and insiders.¹ Finding ways to mitigate that risk through contract provisions that afford outside investors some degree of security has been a subject of interest to academics and practitioners interested in corporate finance and governance for several decades.

According to Jonathan B. Baskin and Paul J. Miranti Jr., it was not until companies resolved this agency problem through contractual arrangements that the basic problem of information asymmetry between insiders and investors was resolved in a way that enabled early corporations to induce outside investors to buy securities on a large scale. In the view of these two authors, “differences in goals and access to knowledge frequently placed investors at a disadvantage in dealing with their corporate agents.” Baskin and Miranti argue that “investor wealth, for example, could be threatened either by corporate agents’ opportunism or, in the extreme case of moral hazard, by dishonesty,” adding that “such risks could be diminished by more effective contracting.” They see as the solution not national legislation but either liens secured against enterprise assets, in the case of bonds, or incentive-compatible contracts that accommodate outside investors through various mechanisms, such as boards of directors to monitor agents. The ultimate solution would be improvements in financial reporting.²

Yet, lately, the focus of the debate has shifted away from firms and contracts to the subject of differences in the extent to which national company laws protect shareholders. A large body of scholarly work,

known as the law and finance literature, maintains that even if companies can enact bylaws that mitigate abuses by managers and other insiders, the inclusion of such protections results, especially in developing countries, in contracts that are exceedingly complex and difficult to enforce (because judges are not trained to interpret and enforce them). For this reason, according to the views expressed in this literature, what matters most for equity-market development are investor protections written into national company and securities laws. Imposing a degree of standardization upon firms makes the corporate charters easier to enforce. Indeed, research has found that equity markets are more developed in countries where legislation has been enacted that guarantees more shareholder protections. In fact, countries that have adopted the common-law legal tradition currently provide stronger protections for investors than countries that follow any of the three families (French, German, and Scandinavian) of civil law. These findings imply (1) that investor protections in national laws are critical to the development of capital markets; and (2) that a country’s legal tradition has a bearing on the kind of investor protections it can provide, as well as a long-term impact on the development of the country’s equity markets.

Using historical evidence on shareholder rights written into corporate charters and ownership concentration, I examine both hypotheses. I am particularly interested in the idea that differences in legal systems produce clear differences in investor protections and financial development over the long run. This argument might appear to be uncomfortably deterministic, as it implies strong path dependence and allows little room for changing circumstances over time. One might ask, What if things were different a hundred years ago? More historical research is needed to determine the degree to which a national institutional environment is governed by its legal origins and to what extent the environment constrains corporations from devising their own contracts to solve the main principal–agent problem.

The company-level evidence from Brazil shows that neither the country’s legal tradition nor its national regulatory regime is necessarily binding. Indeed, companies and their shareholders can overcome adverse institutional environments by devising contracts that stipulate protections for small shareholders, as long as there is a basic regulatory framework that guarantees some of those protections and a judicial system that enforces them. My findings support the claims made in the recent

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research by Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, who argue that the most important legal provisions for promoting the development of stock markets are those that facilitate the private enforcement of investor rights. In making their point, the authors provide examples of laws that either facilitate the disclosure of financial information or make it easy for shareholders to sue directors, insiders, or company founders who commit fraud or violate the company bylaws.5

Evidence is now rapidly growing against the view that legal traditions adopted decades, or even hundreds of years, ago determine how countries go about establishing legal protections for investors and developing equity markets. Research by Raghuram Rajan and Luigi Zingales demonstrates, for example, that German and French civil-law countries had larger equity markets than their common-law counterparts circa 1913.6 More recent research shows that, in the United States, corporate governance practices were less protective of small shareholders in the past than they are today.7 Indeed, during the nineteenth century, there was substantial variation in U.S. corporate governance practices and regulations over time and across states. In recent papers, Leslie Hannah reports that, around 1900, there were notable variations in corporate governance practices worldwide; many differed sharply from the practices of today.8

Between 1890 and 1910, the founders of Brazilian corporations attracted outside investors and maintained concentration of ownership and control at relatively low levels by including in their corporate statutes provisions restricting the power of large shareholders. Archival

evidence drawn from company statutes and shareholder lists reveals that, in many Brazilian corporations, voting-rights provisions, particularly maximum-vote provisions and graduated voting scales (whereby fewer votes are assigned to shareholders as their shareholdings increase), balanced the relative voting power of small and large investors. In contrast, investor protections embedded in national laws were weak and thus not very helpful for the early development of Brazilian equity markets. But even when such provisions were not included in national legislation, as was the case in some U.S. states in the nineteenth century, investor protections in Brazil did not exist in a legislative void.9 Brazilian legislation helped small investors monitor firms’ activities by mandating regular disclosure of financial accounts, including publication of directors’ compensation and imposition of strict penalties for fraud during initial public offerings (IPOs) of stocks and bonds.

The case of Brazil is particularly interesting, because before World War I the country boasted the second-largest equity market and the largest number of traded companies (even when normalized by the size of the country’s economy) in Latin America.10 This is puzzling, since the country was thought to have inherited one of the worst institutional legacies in the Americas. Under Portuguese colonization, Brazil became a Catholic country that embraced the French civil-law tradition, two institutional features that have been linked to small financial markets and weak investor protections.11 High mortality among Portuguese settlers

9Colleen Dunlavy argues that mandatory maximum vote provisions and graduated voting scales included in state company laws in the United States in the middle of the nineteenth century created a more democratic (her word is plutocratic) voting system that constrained the proportion of votes that could be controlled by any large shareholder during shareholder meetings. See Dunlavy, “From Citizens to Plutocrats,” and “Corporate Governance in Late Nineteenth-Century Europe and the U.S.”

10Arguably Cuba had the largest equity market in Latin America circa 1913, yet the number of corporations traded was very small. Also, Raghuram Rajan and Luigi Zingales estimate that in 1913 the stock market capitalization to gross domestic product (GDP) ratio for Brazil was 25 percent, and for both Argentina and Chile, 17 percent. The authors estimate that in that year Rio de Janeiro had 335 listed corporations, São Paulo 145 (excluding cross-listings), giving for the number of traded companies per million people 20.8 (assuming a population of about 23 million). Rajan and Zingales’ estimates of that ratio for that year were for Argentina 15.29, for Chile, 20.62, and for Cuba, 12.69. (See Raghuram Rajan and Luigi Zingales, “The Great Reversals: The Politics of Financial Development in the Twentieth Century,” Journal of Financial Economics 69 (2003): 50, Tables 3 and 5; and Aldo Musacchio, “Experiments in Financial Democracy: Corporate Governance and Financial Development in Brazil, 1882–1950,” unpublished book manuscript, Harvard Business School, December 2007, Tables 3–5 and 3–9.)

and a high proportion of natives (later slaves) to settlers have also been linked to Brazil’s weak rule of law. These relations have been drawn from the fact that, in marked contrast to the period I examine here, modern-day Brazil has a weak rule of law, weak investor protections, and high ownership concentration.

Recent Literature on Shareholder Protections

In their influential series on law and finance, Rafael La Porta and his colleagues argue that minority shareholders are afforded protection by a basic set of principles, or rights, embodied in corporate laws with which companies are obliged to comply. Smaller investors are presumably encouraged by these protections to participate in the ownership of corporations, thereby strengthening equity markets.

La Porta et al. assert that the basic set of small-investor protections incorporated in national company laws should guarantee voting rights for all shareholders (specifically, one-share, one-vote provisions), in addition to six other protections. The authors have created an index of shareholder protections, based on how many of the six safeguards, listed here, are included in a nation’s company laws.

1. Shareholders who are absent from shareholder meetings are permitted to vote by proxy.
2. Shares do not have to be deposited before shareholder meetings (a requirement imposed by some companies in order to prevent shareholders from selling their equity for several days after a meeting).
3. There is a policy of cumulative voting or proportional representation, which ensures that minority shareholders can elect board members.
4. Minority shareholders have either the right to challenge directors and assembly decisions in court or else the option to sell


13 See Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, “The Economic Consequences of Legal Origins,” Journal of Economic Literature 46-2 (June 2008): 285–332, for a summary of the main arguments of the literature (and the long list of publications by these authors).
their holdings and end their participation in the firm, in the event of disagreement with a managerial or assembly decision.

5. Shareholders are given the first option to purchase new stock, enabling them to prevent their company share from being diluted in the event that the assembly decides to expand total equity.

6. The percent of capital required to call an extraordinary meeting is less than, or equal to, 10 percent.14

In coding countries according to how many of these protections were established by national laws in 1995, the authors found that the countries with more protections had larger equity markets (and greater numbers of corporations traded). The extent of these protections was highly correlated with the country’s legal tradition, leading the authors to conclude that “because legal origins are highly correlated with the content of the law, and because legal families originated before financial markets had developed, it is unlikely that laws were written primarily in response to market pressure.”15 Thus, they argue that a country’s level of investor protections is determined by the legal tradition it follows.

However, historical evidence presented in recent research suggests that these investor protections were not necessary for the development of equity markets. Julian Franks, Colin Mayer, and Stefano Rossi found that Great Britain’s stock markets evolved rapidly after 1890, despite the lack of shareholder protections in its national laws. Franks, Mayer, and Hannes Wagner reached similar conclusions in their work on Germany, which developed a significant equity market after 1930 without the benefit of shareholder protections in its national laws. In the case of Germany, banks substituted for explicit legal protections by mediating between investors and companies, thereby providing the protection and trust needed to quell investors’ fear of fraud.16

Finally, Eric Hilt’s research on early New York corporations reveals that corporate bylaws often gave critical protection to small investors in

14 The methodology to estimate the index of shareholder rights comes mostly from La Porta et al., “Law and Finance,” Tables 1 and 2.


the form of voting provisions that limited the power of large shareholders. Colleen Dunlavy also argues that voting rights matter; she points out that company laws in certain U.S. states protected shareholders more strongly when they included mandatory graduated voting scales (i.e., owners had fewer votes per share as their shares increased). Yet those protections disappeared after the 1880s as many of the most industrialized U.S. states began to mandate one-share, one-vote provisions. In fact, even though the United States had some relatively good practices in the earlier part of the nineteenth century, and while it offers strong shareholder protections today, according to Naomi Lamoreaux and Jean Laurent Rosenthal, protections for minority U.S. shareholders were relatively weak during the late nineteenth and early twentieth centuries. Their findings are based on an extensive set of court cases that show directors and large shareholders to have been “engaged in a variety of . . . actions from which they benefited at the expense of their associates.”17

Investor Protections in Brazil

Brazil experienced an initial peak in its equity market between 1890 and 1915, the period I have chosen to study. Table 1 shows the number of companies registered on the Brazilian Stock Exchange per million people, one common measure of financial development (another is the ratio of equity-market capitalization to gross domestic product, as shown in Figure 1). In fact, according to this measure, Brazil was more financially developed in the first half of the twentieth century than it is today. Unfortunately, a law in 1947 forced all joint-stock companies to register in their local stock exchanges, making it impossible to compare the time span from 1947 to 1970 with previous periods. Still, Table 1 shows that circa 1910 there was intense activity in stock markets.

Table 2 outlines the rights embodied in Brazil’s joint-stock-company laws between 1882 and 2001, following the methodology of La Porta et al. The index of shareholder rights on paper (i.e., the shareholder-rights index presented in the bottom row) lists the number of shareholder rights present in national laws that the authors deem relevant to the development of equity markets. According to this measure, Brazilian shareholders enjoyed little protection from directors’ abuses before 1940, which was precisely the time when equity markets first peaked in that century. Only two relevant shareholder protections were

Table 1
Number of Companies Registered at the Exchange per Million Population, 1850–2003

<table>
<thead>
<tr>
<th>Decade/Year</th>
<th>Companies</th>
<th>Decade/Year</th>
<th>Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>1850s</td>
<td>3</td>
<td>1930s</td>
<td>6</td>
</tr>
<tr>
<td>1860s</td>
<td>1</td>
<td>1940s</td>
<td>15</td>
</tr>
<tr>
<td>1870s</td>
<td>2</td>
<td>1950s</td>
<td>49</td>
</tr>
<tr>
<td>1880s</td>
<td>4</td>
<td>1960s</td>
<td>—</td>
</tr>
<tr>
<td>1890s</td>
<td>6</td>
<td>1970</td>
<td>4</td>
</tr>
<tr>
<td>1900s</td>
<td>7</td>
<td>1980</td>
<td>4</td>
</tr>
<tr>
<td>1910s</td>
<td>12</td>
<td>1990s</td>
<td>6</td>
</tr>
<tr>
<td>1920s</td>
<td>11</td>
<td>2000–03</td>
<td>6</td>
</tr>
</tbody>
</table>

Sources: Number of companies from Mária Bárbara Levy, História da Bolsa de Valores do Rio de Janeiro, Tables 8, 18, 24, 38, 47, 57, from the World Federation of Stock Exchanges, Focus, various issues, 2000–03. Population data from Cláudia Contador, Mercado de Ativos Financeiros no Brasil (Rio de Janeiro, 1974), Table A-1.

aData for the 1860s–1950s apply to the Rio de Janeiro Stock Exchange only. In the 1940s and 1950s, all companies were forced to register on the stock exchange, making comparisons with other periods difficult.

Figure 1. Shareholder rights and average stock-market capitalization to GDP, 1890–2003.
(Sources: Table 2 and author's calculations of stock-market capitalization from Jornal do Comércio, Retrospecto Comercial do Jornal do Comércio, Câmara Sindical, Relatorio (1905–26); the Anuário da Bolsa de Valores do Rio de Janeiro (1926–42). São Paulo data were taken from Hanley, “Business Finance,” and from the Anuário da Bolsa de Valores de São Paulo, 1932–43. GDP data from Goldsmith, Brasil, Tables 3.1, 4.2; and Instituto Brasileiro de Pesquisa Econômica’s databases, www.ipedata.gov.br. São Paulo Stock Exchange data are missing for 1920, 1925, and 1935. Data for 1947–64 are excluded because legislation forced all joint-stock companies to register at the stock exchange, resulting in data that were not comparable to other periods and with other countries.)
binding on all corporations in Brazil until 1940. From 1882 until 1891, all corporations had to allow proxy voting and were not permitted to require shareholders to deposit their shares before assemblies. When the latter prohibition was overturned in 1891, shareholders in possession of bearer shares were required to deposit them with the company and register their names in order to vote in shareholder meetings. This provision was not specifically designed to restrict or constrain shareholders, but was, rather, a mechanism for maintaining a registry of those who would be voting in shareholder assemblies.

Shareholder rights were strengthened on paper in 1891, when Brazil’s new company law introduced the right to challenge in court directors’ decisions that contradicted any company statute. After 1882, moreover, shareholders could, individually or as a group (i.e., via class action), sue and hold directors personally liable for decisions that caused them a loss.\(^{18}\)

\(^{18}\) See Law 3150, 4 Nov. 1882, especially Article 11 and Decree 603, 17 Oct. 1891, Article 189, blocking shares before meeting, and Article 209, allowing legal action against directors.

### Table 2
Shareholder Rights in Brazil, 1882–2001

<table>
<thead>
<tr>
<th>Rights</th>
<th>1882</th>
<th>1890</th>
<th>1891</th>
<th>1940</th>
<th>1976</th>
<th>1995(^{a})</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proxy voting</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Shares not blocked before meeting</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Cumulative voting or proportional representation</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Provision for minorities to challenge directors’ decisions(^{b})</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Shareholders given first right to buy new stock</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Capital needed to call an extraordinary meeting less than or equal to 10%</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Anti-director rights index(^{c})</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>5</td>
<td>6</td>
<td>3</td>
<td>6</td>
</tr>
</tbody>
</table>

Sources: Law 3150, Nov. 4, 1882; Decree 164, Jan. 17, 1890; Decree 434, July 4, 1891; and Decree 603, Oct. 17, 1891, Decreto-Law 2627, Sept. 26, 1940, Laws 6404, Dec. 15, 1976, and 10,303, Oct. 31, 2001, from Brazil. Leis e Decretos (Rio de Janeiro and Brasilia, 1882–2001).\(^{a}\) Rights for 1995 follow the classification of La Porta et al., “Law and Finance,” Table 4.\(^{b}\) Withdrawal rights (allowing a shareholder to walk away with a fair share of total equity) were temporarily suspended between 1997 and 1999.\(^{c}\) The anti-director-rights index sums the number of shareholder rights in existing company laws by period.
Even with few shareholder protections on paper, Brazil enjoyed its first peak in stock-market activity between the late 1880s and 1915. In fact, a tenuous relation seemed to exist between shareholder protections in national laws and stock-market development, in that, by the time additional protections for minority shareholders were written into law in 1940, stock markets were already in decline. Moreover, if the literature relating equity-market size to shareholder rights holds, Brazil’s equity markets should have prospered between 1940 and the 1990s, when investor protections were strong (Table 2), and their capitalization should have jumped significantly in size after 2001 (following the passage of laws detailing even more protections). But this is clearly not how events evolved. As Figure 1 shows, the first peak in Brazil’s stock-market development occurred before 1940. A period of nearly half a century of relatively small equity markets ensued, followed by a decline in the 1980s and then, since 1994, rapid expansion. Some correlation between the level of stock-market development and investor protections can be observed, but, between 1940 and 1976, there was no correlation at all. Moreover, the years after 1976, during which relatively strong shareholder rights prevailed (this outcome excludes the 1995 survey by La Porta et al., which probably overlooked some rights), are precisely the years during which Brazil has been portrayed as one of the worst countries in which to be a small investor.

The organization of voting rights has also been advanced as an important incentive (or disincentive) to participate in stock markets. The statistical results reported by La Porta et al. show that countries in which national laws mandate one-share, one-vote provisions have larger financial markets. But few countries’ national laws incorporate this provision; for the most part, corporations decide individually how many shares are required before a shareholder is allowed one vote in the annual general meeting.

In the next section, I will review past company bylaws in Brazil, which reveal significant variation in voting schemes.

19 See Decree-Law 2627, 1940. Articles 17 and 107 permitted shareholders who disagreed with directors or assembly decisions to walk away from the company with the share of net worth that corresponded to the lot of shares held. The 1940 law included the right of minority shareholders to elect members of the board of overseers. Any group of shareholders, ordinary or preferred, that represented at least 20 percent of capital that disagreed with the election of a member of that board (conselho fiscal) could name one member of its preference.

20 The literature that studies “private benefits of control,” or the nonpecuniary benefits of those who control a corporation, finds that in the 1990s Brazil was the country with the highest expropriation of shareholder value by controlling shareholders. See Tatiana Nenova, “Control Values and Changes in Corporate Law in Brazil,” in Latin American Business Review 6, no. 3 (2005): 1–37; and Luigi Zingales and Alexander Dyck, “Private Benefits of Control: An International Comparison,” Journal of Finance 49 (Apr. 2004): 537–600.

21 La Porta et al., “Legal Determinants of External Finance.”
National Laws That Protect Shareholders

If the legal protections listed in Table 2 did not make investors eager to participate in financial markets before 1940, what did motivate them? The growth of stock markets before 1940 attests to investors’ trust in securities issuers. In order to maintain trust in an environment that provided minimal government monitoring of corporate activities, investors needed access to accurate information about companies’ finances, leadership, and largest shareholders. They also had to become informed about the degree to which insiders or large shareholders had power to manipulate directors, appoint managers, and countermand the institutional course established by managers.

Brazil mandated legal protections for shareholders that extended beyond limited liability. The Company Law of 1882 required Brazilian corporations to publish a wide array of financial and governance information. All corporations had to hold at least one general shareholder meeting per year, and shareholders were permitted to examine their companies’ books one month before the annual meeting. Following the meeting, and after its financial statements were approved by the board of overseers, the company had to publish a balance sheet with additional details on profits, reserves, and dividends paid, and it had to disclose all transfers of shares during the year. Although transfers of shares were announced only in companies’ official annual reports, balance sheets published once or twice per year by the financial press were widely circulated throughout the state in which a firm operated. Net profits (as dividends plus change in reserves plus changes in other retained earnings) were readily inferred from these balance sheets, and after 1891 corporations operating in Brazil were also required to publish profit-and-loss statements.

Brazilian financial statements were neither more sophisticated nor more regular than those issued by British companies at the time. However, since 1882, Brazilian legislation had required that all companies publish financial statements, whereas similar British legislation did not appear until around 1900. In England, disclosure of financial statements was required for railways in 1868, insurance companies in 1870, gas utilities in 1871, and electric utilities in 1882; other industries had to

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22 See Law 556, 25 June 1850, Article 298 and Law 3150, 4 Nov. 1882, Article 16.
23 Law 3150, 4 Nov. 1882, Articles 15 and 16. The overseeing board was composed of three shareholders elected at the shareholders’ meeting usually to a term of three years. Most of the provisions that regulated the overseeing board were mandated by law.
24 Decree 603, 20 Oct. 1891, Article 211 required directors to prepare and publish in a newspaper a balance sheet and a profit-and-loss statement one month before the annual general shareholders’ meeting.
await subsequent legislation. At the New York Stock Exchange, disclosure was not required for domestic listed companies until 1895.25

Of course, financial disclosure in Brazil was far from perfect. As in England, “depreciation accounting rules were not well developed,” and “directors could create secret reserves by understating profits in good years, raiding them—without disclosing this—in bad.”26 Nor did the existence, since 1882, of mandatory disclosure and limited liability prevent a subsequent major crisis of investor confidence. After 1888, the money supply rapidly increased when the rules constraining banks from issuing bearer notes were relaxed. This situation intensified in November 1889, when the republican movement overthrew the constitutional monarchy that had ruled Brazil since independence. At that point, in addition to the notes being issued by the banks, the new minister of finance, Rui Barbosa, created a national system of reserve banks that were authorized to issue bank notes in order to expand the money supply. The resulting upsurge in the supply was accompanied by an increase in bank loans, fueling a boom in stock-market activity.

This speculative fever, called the encilhamento, had perverse effects on some shareholders of the companies that went bust in 1891. The long-term crisis that would have resulted from loss of investor confidence in joint-stock corporations was averted by the legislative reaction. The Ministry of Justice asked Dídimo Agapito Veiga Júnior, an expert in company law, to draft a new law that would prevent further corporate fraud. Veiga Júnior’s approach to company law was consistent with the liberal tradition that permeated the ideology of the new republican government. He believed that “the interested parties [i.e., the shareholders] are the ones concerned about protecting their rights through clear and protective bylaws.”27 Guided by this ideology, Veiga Júnior drafted a law that gave shareholders most of the responsibility for monitoring company founders, managers, and other shareholders.

Among Veiga Júnior’s recommendations was one that entailed protecting investors against fraudulent practices by company promoters and deceptive prospectuses published by securities issuers. Decree 603 of October 20, 1891, for example, required the prospectus for a new share issue to name the company founders, provide the details of the company’s contracts with the bankers or financiers involved in the operation, and list the amounts paid by the company to these intermediaries in the

25 See Baskin and Miranti, A History of Corporate Finance, 141; and Hannah, “Pioneering Modern Corporate Governance,” 15–17.
26 Hannah, “Pioneering Modern Corporate Governance,” 19–20.
form of commissions or fees. More important, the prospectus had to be accompanied by a copy of the company statutes after their publication in a newspaper that had a wide circulation.\textsuperscript{28} In fact, since 1882, all new corporations had been required to publish their statutes before commencing operations or trading their shares. Decree 603 not only regulated the issuing of shares more stringently; it also provided criminal penalties (including jail sentences and monetary fees) for directors or promoters of new companies who provided false information or violated the bylaws of the corporations for which they worked. Similar penalties (absent jail sentences) were promulgated for members of the overseeing board of directors (\textit{conselho fiscal}) who approved fraudulent practices during their terms.

 Passage of Brazil’s Company Law in 1891—mandating private disclosure and requiring founders and promoters of new corporations to publish and publicize their statutes and shareholder lists, their bylaws regulating corporate governance, and the details of executive compensation, voting rights, and share ownership—afforded investors the means to monitor managers and insiders and to evaluate prospective investments. A small investor who was considering buying shares in a company could determine, for example, how powerful the large shareholders were by examining the size of their shareholdings and voting power, and thus, at the outset, they would know who the directors were, how many shares and votes they controlled, and the amount of their fixed and performance-based compensation.

 Other protections were left up to a corporation’s founders and shareholders to decide. Drafts of company statutes often contained certain important safeguards, such as the following: the right of minorities opposed to a merger to sever relations with the corporation and take with them a payment of either their share of the total equity or the value of their shares according to the merger offer (whatever amount was higher); exclusion of family members from serving on the managing and overseeing boards of directors simultaneously (a provision seldom respected); and a requirement that managers not engage in business deals with family members or related firms without first informing the corporation.\textsuperscript{29} Coincidentally, the disclosure requirements that became part of Brazilian law after 1891 have recently been linked to the development of equity markets around the world. In recent revisions to the list of rights they

\textsuperscript{28} See Decree 603, 20 Oct. 1891, Articles 89, 90 and 105. See also, Law 3150, 4 Nov. 1882, Article 3.

\textsuperscript{29} See Decree 603, 20 Oct. 1891, Article 282 (for shareholder rights in mergers), 148 for restrictions on transactions with family members, and 165 for constraints on family members serving on boards.
consider critical for financial development, La Porta, Lopez-de-Silanes, and Shleifer cite, among other indicators, what they call an “index of disclosure requirements” that is highly correlated with different measures of stock-market size. Although calculations based on this index are not as straightforward as the ones used for shareholder rights, the index is higher when a company prospectus meets the following conditions:

1. When, by law, it must be published before the sale of shares.
2. When it discloses the compensation of directors and key officers.
3. When it discloses the names and ownership stakes of shareholders who control, directly or indirectly, 10 percent or more of the voting shares.
4. When it discloses the share ownership of directors and key officers.
5. When it discloses for the issuing company any contracts outside the ordinary course of business.
6. When it discloses transactions between the issuing company and its directors, officers, or large shareholders.

The index is estimated by adding how many of these protections are present.30 After 1891, Brazil had enacted at least the first four provisions, yielding an estimated index of 0.66 (or 4/6).

The level of mandatory disclosure of information was higher in Brazil than in Germany or England, at least until 1929. Franks, Mayer, and Rossi estimate that England required only that a prospectus be issued, and Franks, Mayer, and Wagner report that Germany had none of the index’s disclosure requirements.31 To gauge the significance of this relative to contemporary standards, if Brazil today had these same provisions (and associated index of 0.66), it would be one of the three French civil-law countries with the strongest disclosure requirements, which would be similar to those of Ireland, Israel, and New Zealand among common-law countries.32

In sum, Brazilian company law preferred to leave to investors the task of regulating financial markets, and it included provisions to help them gather the necessary information to do this job. Beyond the information mandated to be disclosed, actual protections that induced shareholders to purchase equity mostly took the form of bylaws added to corporate statutes, some of which will be explored in the next section.

30 La Porta, Lopez-de-Silanes, and Shleifer, “What Works in Securities Laws?” 1–32; for the methodology of the index, see Table 1.
31 See Franks, Mayer, and Rossi, “Ownership: Evolution and Regulation,” Table 1, Panel D; and Franks, Mayer, and Wagner, “The Origins of the German Corporation,” Table 3, Panel B.
32 See La Porta, Lopez-de-Silanes, and Shleifer, “What Works in Securities Laws?” Table 2.
Investor Protections in Company Bylaws

Two provisions for protecting small shareholders, government guarantees and voting rights, may have most effectively encouraged investment in Brazil’s traded corporations.

**Government Guarantees.** Federal and state government subsidies to corporations that translated into protections or incentives for shareholders typically took one of two forms. One, usually associated with railway corporations, banks, and some utilities, was a guaranteed minimum dividend paid directly to shareholders through a transfer from the government. The other was the granting of privileges, such as exemptions from paying taxes or duties or the awarding of a direct government subvention each year. Shareholders benefited, of course, from reduced uncertainty about corporate performance and payment of dividends. Perhaps the most reassuring factor for shareholders was that corporations receiving government guarantees were subject to more intense monitoring by government officials. By law, a government representative had the right to audit shareholders’ meetings and to revise the financial statements of beneficiary corporations.33

Government-guaranteed dividends, probably modeled after American, British, or Canadian practices at the time, helped to bridge the information asymmetries that prevailed during the initial stage of railway development in Brazil.34 In 1852, not many took advantage of the government’s offer of concessions to build railroads in different parts of the territory.35 Even into the 1860s and 1870s, Brazilian stock markets were not yet sufficiently prepared to finance extensive ventures, and foreign investors wanted more guarantees before they were willing to put money into businesses whose promised results were uncertain.

Thus, the imperial government guaranteed an annual dividend of approximately 5 percent of equity per company, which provinces could complement with an additional dividend subsidy of 2 percent. If net profits exceeded the government-guaranteed amounts, the surplus had

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33 See, for example, Decree 603, 20 Oct. 1891, Articles 125 and 126.
35 Some of the earliest railroad companies were not particularly successful, a number failing altogether. The railroad Dom Pedro II, for example, established to transport coffee from the Paraíba Valley to the port of Rio de Janeiro, had to be bailed out in 1865 when it ran out of funds to complete construction. See Flávio A. M. Saes, *A Grande Empresa de Serviços Públicos na Economia Cafeirica* (São Paulo, 1986), 37–38.
to be divided between the company and the government. These subsidies, which proved to be a powerful incentive, facilitated the rapid development of railway companies in Brazil.

Because the subsidies also provided incentives for excessive risk-taking by managers and founders, the government rigorously regulated and monitored some of these companies. For example, before any other Brazilian corporations were subject to such restrictions, the railways had to publish their complete financial information, including profit-and-loss statements. As most of the companies that were awarded these subsidies operated government concessions for railway lines, utilities, ports, or waterworks, a business reverted to the government if its contract was violated in any way or if the company was driven into insolvency.

Voting Rights. More important than the many disclosure requirements were the provisions that divided power among shareholders. Bylaws that established the voting rights of shareholders were critical to encouraging the participation of small investors in equity ownership. There are only a few scenarios that would motivate small investors to participate in the ownership of a corporation in which voting power is controlled by a large shareholder. As most investors prefer a situation in which the balance of power is not tilted toward insiders, directors, or large shareholders, a significant number of Brazilian corporations (mostly before 1910) structured their voting rights in a way that would distribute power more evenly among shareholders. Before 1932, there were no shares without voting rights in Brazilian corporations; any shareholder who held the requisite number of shares could vote and thus participate in a company’s decision-making process. About a third of Brazilian corporations capped the maximum number of votes in order to limit the power of large shareholders, and many large corporations employed graduated voting schemes, thereby restricting the number of votes that accompanied increased shareholdings.

36 On the history of the expansion of railroads and subsidy policies, see William R. Summerhill III, Order Against Progress: Government, Foreign Investment, and Railroads in Brazil, 1851–1913 (Stanford, 2003), ch. 3; and Flávio A. M. Saes, As Ferrovias de São Paulo, 1870–1940 (São Paulo, 1981), 151–54. A more detailed contemporary account is provided by Chrockatt de Sá, Brazilian Railways; Their History, Legislation and Development (Rio de Janeiro, 1893).

37 This was the case of the Sorocabana Railway in 1902 and the E. F. Dom Pedro II in 1865. See Estrada de Ferro Sorocabana, Relatório: Anno de 1904 (São Paulo, 1905) for a description of the acquisition of the assets of the Sorobana by the federal government; and Saes, A Grande Empresa de Serviços Públicos na Economia Cafeeira, 36, for the story of the E. F. Dom Pedro II.

38 This might be the case when two rival groups with large shareholdings monitor one another or when a large shareholder with a good reputation monitors the actions of directors or founders. In both cases, small shareholders would buy equity as a way to free ride on the monitoring efforts of the large shareholders.

39 Article 15 of Law 3150, 4 Nov. 1882 stated that voting rights were to be established by each company in its bylaws.
From a survey of companies published in the *Brazilian Year Book 1909* (a handbook of Brazilian corporations published in London), we know that the average number of shares needed to secure the right to vote was relatively low in most of the industries surveyed in 1909. On average, Brazilian corporations required that investors hold between five and ten shares in order to vote at shareholder meetings. Approximately 20 percent of the companies surveyed had one-share, one-vote provisions. Banks seem to have been particularly democratic, since 46 percent of them had a one-share, one-vote provision. Companies in utilities, ports, and mining were not far behind: 30 percent adopted this voting provision. Other companies settled on either five shares per vote (37 percent of firms) or ten shares per vote (34 percent). Only 7 percent of companies required ownership of from twenty to twenty-five shares before permitting the shareholder to cast one vote. According to this survey, more than a quarter of the companies in the 1909 sample limited the maximum number of votes that a single shareholder could cast during a given meeting. On average, 26 percent of companies capped the maximum number of votes, while 38 percent of companies in the utilities and shipping industries included such caps. Although no companies in services and mining were reported to have used this voting scheme, the sample size for those sectors was too small to obtain an accurate picture of them.40

Capping the maximum number of votes protected smaller shareholders in two ways: by limiting the power large shareholders could exert during shareholder meetings; and by encouraging the formation of large voting blocs that included smaller shareholders as a way to reach a consensus on important matters, such as assembly resolutions and the election of directors. The decision-making process was thereby rendered more democratic, as smaller investors were encouraged either to participate more actively in shareholder assemblies or at least to decide which voting blocs they wanted to join.

Some corporations adopted graduated voting rights, limiting the number of additional votes that accompanied increases in shareholdings. As a result, in companies such as the brewery Antarctica, the railways E. F. Paulista and E. F. Mogyana, and the bank Banespa, the percentage of shares controlled by the largest shareholders was higher than the percentage of votes they controlled. Why shareholders with large equity holdings were willing to settle for disproportionately lower

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40 These figures are based on a compilation of voting rights data for all the companies surveyed in the *Brazilian Year Book 1909* (London, 1910). Unfortunately not all companies surveyed in this publication reported voting rights. There were 135 companies that reported voting rights. These companies were from all over Brazil.
control rights is open to conjecture. Perhaps many Brazilian investors shared a “democratic” attitude toward corporate governance.

That Brazilian companies, on average, had relatively low ratios of shares per vote does not translate, however, into worker participation in the ownership and control of corporations. Data on average annual salaries by profession in Rio de Janeiro in 1909 show that the cost of a single share (with face value of 200 mil reis) equaled the entire annual salary of a cook, carpenter, or messenger; other, relatively unskilled, workers earned less per year than the face value of one share (normally either 100 or 200 mil reis); and most jobs at the time paid an average wage of between 100 and 200 mil reis per year. Thus, the reference to “democratic” practices of corporate governance should not be construed to extend beyond the realm of landowners, professionals (e.g., lawyers, accountants, bankers, dentists, and engineers), widows, urban landlords, and other citizens with relatively high incomes or sizable inheritances who could buy corporate stocks.

Some corporations included in their bylaws provisions to limit abuses by large shareholders or families with significant shareholdings. The Mogyana Railway and textile mills São Paulo Fabril and Fábrica de Tecidos Esperança, for example, capped not only the number of votes per shareholder, but also the maximum number of votes any single shareholder could hold in proxy for other shareholders.

Voting Rights and Ownership Concentration, 1890–1950. How much shareholder protections mattered in practice to smaller investors is reflected in tangible outcomes, such as low levels of concentration of ownership and control in large Brazilian corporations. Ownership concentration is a good indicator of the state of shareholder protections for at least two reasons: Smaller investors who are unsure of the degree to which they are protected against the abuses of managers or other shareholders would be unlikely to participate actively in equity markets. Then, in the presence of weak shareholder protections, there would be little to stop managers from pilfering company resources. Ownership concentration would compensate for inadequate shareholder protections, because shareholders with large blocks of shares and votes would have an incentive to monitor managers, as well as the power to dismiss anyone who committed abuses and appoint a replacement.

Data for a sample of the largest Brazilian corporations between 1890 and 1940 show that ownership concentration in corporations whose

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41 For salary data, see Mária Eulália Lahmeyer Lobo, História do Rio de Janeiro: Do capital comercial ao capital industrial e financeiro (Rio de Janeiro, 1978), Table 4.44.

42 See Cia. Mogyana (Mojiana) de Estradas de Ferro, Relatório da Diretoria em Assembleia Geral . . . (Rio de Janeiro, 1878–1922); and Estatutos da Companhia São Paulo Fabril (São Paulo, 1890).
bylaws contained more protective shareholder rights was lower than in the average company. Shareholder lists for some of the largest Brazilian corporations were compiled from data available at the Rio de Janeiro Stock Exchange Archive in Rio de Janeiro and the São Paulo State Archive in São Paulo. Most company statutes, voting rights, and shareholder lists were obtained from published reports in newspapers. The disclosure requirements that have been in place since 1882 stated that financial statements, shareholder lists, and company statutes had to be published in a major newspaper, but since they did not specify which one, collecting systematic data on Brazilian corporations requires skimming many newspapers published in many states. For this article, I looked at the company statues available in the Diário Oficial do Estado de São Paulo (Official Gazette of the State of São Paulo), the newspaper O Estado de São Paulo, and the Diário Oficial da União (Official Gazette of the Federal Government). I collected the available shareholder lists and statues for companies that had a capitalization equivalent to the average market value of a publicly traded company in 1913 (around 1,000,000$000 or US$300,000). Table 3 shows the average concentration of ownership by industry in the Brazilian corporations I included in my sample. Concentration of ownership and control was estimated by compiling the percentage of shares and votes controlled by the largest three shareholders. Additionally, the concentration of control was estimated using the Herfindahl-Hirschman Index (HHI), a common measure of market concentration, which adds up the squared share of each shareholder’s votes.

Table 3 shows significant differences in the average HHI of voting concentration and in the concentration of equity and votes controlled.

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43 The sample studied was compiled by looking at all of the files of companies listed in the Rio de Janeiro Stock Exchange, from the Arquivo da Bolsa de Valores do Rio de Janeiro, housed at the National Archive of Brazil. I only included companies with more than 1,000,000$000 of 1913 in capitalization (the equivalent of US$330,000). The sample also includes all the companies with complete shareholder lists that I found at the São Paulo State Archive. The sample is limited by the fact that I only include companies for which I have complete shareholder lists.

Both archives have special sections on Sociedades Anônimas, with files for each company that usually include company statutes, shareholder lists, and changes to statutes every time there was a bond or new share issue. See, for example, the Sociedades Anônimas collection in the National Archive of Brazil, Rio de Janeiro.

44 The Herfindahl-Hirschman Index is a convenient measure of concentration because its inverse (i.e., 1/x) gives the equivalent number of shareholders needed to have a specific level of concentration. For instance, say a company with 200 shareholders had a few shareholders holding a proportion of shares such that the HHI is 0.20 (by definition it is always between 0 and 1). This would be the equivalent of a company that had five shareholders with equal shares (or 1/0.20). Even if there are 200 shareholders, an HHI of 0.20 tell us that there is relative concentration of ownership. On the HHI and some of its interpretations, see M. A. Adelman, “Comment on the ‘H’ Concentration Measure as a Numbers-Equivalent,” Review of Economics and Statistics 51 (Feb. 1969): 99–101.
The three largest shareholders in companies with and without voting caps. In companies with maximum-vote provisions, the three shareholders with the largest holdings controlled, on average, 55 percent of the stock and 56 percent of the votes. With these levels of concentration, the average HHI was 0.24, the equivalent of having a corporation controlled by four shareholders with equal holdings. In contrast, in companies with maximum votes, the three largest shareholders controlled, on average, only 36 percent of the stock and 22 percent of the votes, yielding an 0.07 HHI of voting concentration, the equivalent of a company with approximately fourteen shareholders who had equal holdings, a significantly lower level of concentration overall. The difference-of-means test displayed at the bottom of the table shows these differences to be statistically significant.

The Antarctica Brewery, which was dominated by a few families of German immigrants with large shareholdings, employed voting caps.

### Table 3
Concentration of Ownership and Control in Brazilian Corporations with Maximum Vote Provisions

<table>
<thead>
<tr>
<th>Industry</th>
<th>Companies without Maximum Votes</th>
<th>Companies with Maximum Votes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. of Firms</td>
<td>Top Three Shareholders</td>
</tr>
<tr>
<td>Agriculture</td>
<td>1</td>
<td>0.50</td>
</tr>
<tr>
<td>Airline</td>
<td>1</td>
<td>0.61</td>
</tr>
<tr>
<td>Banking</td>
<td>15</td>
<td>0.39</td>
</tr>
<tr>
<td>Conglomerates</td>
<td>5</td>
<td>0.77</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>8</td>
<td>0.52</td>
</tr>
<tr>
<td>Other</td>
<td>5</td>
<td>0.64</td>
</tr>
<tr>
<td>Textiles</td>
<td>18</td>
<td>0.63</td>
</tr>
<tr>
<td>Transportation</td>
<td>7</td>
<td>0.49</td>
</tr>
<tr>
<td>Utilities</td>
<td>4</td>
<td>0.53</td>
</tr>
<tr>
<td>Full sample</td>
<td>64</td>
<td>0.55</td>
</tr>
</tbody>
</table>

Difference of means<sup>a</sup>
- 0.19 | 0.34 | 0.17

<sup>a</sup>Companies with maximum votes versus those without.

<sup>b</sup>Significant at 1%.

In fact, the concentration of share ownership was quite large (the top three shareholders controlled 62 percent of the equity). But owing to the maximum-votes-per-shareholder restriction (of forty votes), these families had to broker deals to share power. As an additional check on possible abuses by a single family, the company bylaws included a provision that prohibited two members of the same family from serving on the board simultaneously.\textsuperscript{45}

Voting caps and graduated voting rights together reduced concentration of control significantly in companies such as E. F. Paulista and E. F. Mogyana. In the 1890s, the largest three shareholders of Paulista and Mogyana owned 10 percent and 13 percent of the total shares, but in most shareholder meetings they controlled only 7 percent and 10 percent of the votes, respectively. The cap on the maximum number of votes was increased as the capital of these companies expanded, and it disappeared altogether in some companies as share issues accelerated during the boom years of stock-market activity (1890–1913). In the case of E. F. Paulista, dispersion of ownership continued until the company was bailed out by the government in the 1960s.

The reasons that railways ended up with such dispersed ownership vary. One was that the dividends of railway companies were guaranteed by the federal and state governments, a situation that would be expected to encourage smaller shareholders’ participation in the companies. Then, too, railways were owned by their main beneficiaries, in this case, coffee planters. The shareholder lists of the most important railway lines of São Paulo read like the Who’s Who of coffee plantations.\textsuperscript{46} Finally, there is the obvious element of magnitude. Railways required a lot of capital and thus were more likely to have larger numbers of shareholders.

A similar voting-rights structure militated against concentration of control in smaller firms, such as Companhia Petropolitana, a textile mill. This company began as a family business outside Rio de Janeiro in the 1890s. When it was chartered, the shareholder list showed that the ownership was concentrated in the hands of the few founders, who likely introduced a cap on the maximum number of votes as a check on each other’s power. But as the company expanded and began to rely on equity issues to finance its growth, the number of shareholders increased. Ownership was relatively dispersed by 1928, and voting caps


\textsuperscript{46} See Anne Hanley, “Is It Who You Know? Entrepreneurs and Bankers in São Paulo, Brazil, at the Turn of the Twentieth Century,” \textit{Enterprise and Society} 2, no. 2 (2004): 187–225, for a description of some of the relations between these coffee planters and their role in the network of investors and directors in São Paulo.
reduced the voting power of some of the largest shareholders even more: the top three shareholders controlled 20 percent of equity, but only 12 percent of the votes.47

It might also be expected that government-guaranteed dividends affected concentration of ownership. About one-fifth of the companies in the sample enjoyed this investor protection and, as can be seen in Table 4, companies with government guarantees apparently had a lower concentration of both ownership (shares) and, especially, control rights (votes). On average, government guarantees reduced the percentage of shares and votes that the three largest shareholders controlled by almost 20 percent (these differences are statistically significant at 5 percent and 10 percent, respectively). Yet, there are no significant differences in the HHI of companies with government guarantees.

Table 5 reports a significantly lower concentration of ownership and control in companies with graduated voting schemes than in the other companies in the sample. The differences between the average Brazilian company and companies with graduated voting scales are suggested by the following numbers: the HHI is only 0.08 for the firms with graduated scales, and their three largest shareholders controlled, on average, 24 percent of the votes and 30 percent of the shares. In companies without such voting arrangements, the largest three shareholders controlled 55 percent of the shares and 53 percent of the votes; their HHI was 0.22. Concentration of ownership and control in most companies was thus more than twice what it was in companies with graduated voting scales.

Analyzing the effects of these three governance provisions on ownership concentration is difficult, because they overlapped significantly. For example, Banespa had government-guaranteed dividends and graduated voting, whereas some of the railway companies had graduated voting and maximum votes. Also, controlling for industry diminishes the effects of graduated voting, as most companies with these provisions were in the transportation sector (mostly railways). In fact, in the case of sectors that have companies with graduated voting schemes, it is not clear that significant differences in ownership concentration existed among companies of the same sector that lacked those provisions. In a multivariate regression that controls for company characteristics, such as industry and size (using capital as proxy), maximum-vote provisions and government guarantees have the strongest effects, reducing ownership concentration by half. The effect of a graduated

voting scale on ownership concentration, in contrast, is not significantly different from zero.

Another problem with the analysis is that the maximum-vote provisions and graduated voting rights did not endure, as they tended to disappear from company bylaws over time. In 1926, for example, when the government became a large shareholder, Banespa, the largest bank in São Paulo, changed its statutes and abandoned graduated voting rights.48

48 The changes made by shareholders to the statutes of Banespa in the extraordinary shareholders’ meeting of May 29, 1926 are reported in “Decreto n. 17544—de 10 de Novembro de 1926,” in Diario Oficial do Estado de São Paulo, 4 Jan. 1927. The concentration of control in the bank is clear in the extraordinary shareholders’ meeting of October 11, 1933 reported in “Decreto N. 2—de 25 de Julho de 1934,” in Diario Oficial do Estado de São Paulo, 15 Aug. 1934. For the Matarazzo company example, see the detailed description in the section dealing with family-controlled corporations.
The Aggregate Evidence on Ownership Concentration. Still, owing to the investor protections in corporate bylaws, the concentration of rights of control in Brazil’s traded corporations was generally lower in the past than it is today. Before 1910, the three largest shareholders controlled, on average, between 50 percent of shares and approximately 50 percent of total votes.\(^49\) By 2004, the three largest shareholders of the largest twenty companies in Brazil held 51 percent of the shares and 77 percent of the votes. Most of this growing concentration of control rights can be attributed to the introduction of non-voting preferred shares in 1932, which reduced the cost of controlling

\(^{49}\)This was estimated using data in the Appendix, but excluding repeated observations for companies with multiple observations, taking the average by company. Data for 2004 are estimated using the Economatica database and selecting the top 20 companies on the basis of total assets as reported by Bovespa (São Paulo’s Stock Exchange).

| Industry       | No. of Firms | Top Three Shareholders |  |  |  | Top Three Shareholders |  |  |  | HHI |
|----------------|--------------|------------------------|  |  |  |                 |  |  |  |     |
| Agriculture    | 1            | 0.50                   | 0.50 | 0.12 | — | — | — | — | — | — |
| Airline        | 1            | 0.61                   | 0.61 | 0.33 | — | — | — | — | — | — |
| Banking        | 10           | 0.45                   | 0.45 | 0.30 | 5  | 0.27 | 0.24 | 0.05 |
| Conglomerates  | 8            | 0.64                   | 0.58 | 0.23 | — | — | — | — | — | — |
| Manufacturing  | 12           | 0.54                   | 0.44 | 0.17 | — | — | — | — | — | — |
| Other          | 5            | 0.64                   | 0.64 | 0.20 | — | — | — | — | — | — |
| Textiles       | 25           | 0.55                   | 0.52 | 0.22 | 2  | 0.97 | 0.94 | 0.47 |
| Transportation | 3            | 0.66                   | 0.87 | 0.30 | 14 | 0.21 | 0.14 | 0.04 |
| Utilities      | 4            | 0.53                   | 0.53 | 0.17 | — | — | — | — | — | — |
| Full sample    | 69           | 0.55                   | 0.53 | 0.22 | 21 | 0.30 | 0.24 | 0.08 |

Difference of means\(^a\) 0.26 0.29 0.14
\(t\)-statistic 3.73\(^b\) 3.91\(^b\) 2.46\(^b\)


\(^a\)Companies with graduated voting versus those without.

\(^b\)Significant at 1 percent.
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da corporation and enabled controlling shareholders to obtain equity finance without sacrificing their control rights.

Moreover, ownership concentration in Brazil before 1910 was not high relative to average ownership concentration in England during the same period. In a sample of forty British firms between 1900 and 1910, the largest shareholders were estimated to have controlled between 53 percent and 64 percent of total voting equity, a level that was slightly higher than the average for Brazil. This is particularly impressive, in view of the fact that London was the most developed financial center of the time.50

*Family-Owned Corporations.* Do these results imply that most corporations in Brazil were widely held before the 1920s? Not really. The other ownership pattern that prevailed in Brazil after 1890 was the family-controlled corporation, in which family members held large blocks of shares and occupied most managerial positions. An example of a family-owned corporation was the Companhia Fabricadora de Papel (Klabin), controlled by the Klabin family, whose members occupied three of five directorships from the time of the company’s beginning. Eight of the company’s thirty-six shareholders were family members. Of the top five shareholders, only one was not an immediate family member; the other four were three brothers and the partnership Klabin Irmãos & Comp. (a firm of the Klabin brothers). These five shareholders controlled 75 percent of the firm’s equity.

In fact, the corporation was organized somewhat like a partnership. All shareholders had one vote per share, and the directors did not have a fixed salary until 1937. Profits were divided among the directors and the shareholders, following a formula that guaranteed 10 percent of profits to directors, plus an extra 20 percent of any amount left over after payment of a 12 percent dividend. In 1937, the company gave the partnership Klabin Irmãos & Comp. control of 75 percent of total equity in exchange for an agreement of forgiveness for accumulated debt. The Klabin family continued to expand its empire, and by the 1970s it controlled one of the largest business conglomerates in Brazil and made the list of the top one hundred business groups every year.51

No family was more prominent in Brazilian business during the early part of the twentieth century than the Matarazzo family. In the 1890s, Count Francisco de Matarazzo and his family started a trading business, selling staples and imported goods to coffee plantations in the

51 See “Estatutos da Companhia Fabricadora de Papel (Klabin),” in Diário Oficial do Estado de São Paulo, 6/15/1909; and “Cia. Fabricadora de Papel (Klabin),” in Diário Oficial do Estado de São Paulo, 5/8/1937. For the list of top business groups, see the magazine Balanço, part of the newspaper Gazeta Mercantil.
interior of the state of São Paulo.\textsuperscript{52} Importing know-how and resources from Europe, this Italian family expanded rapidly into processing sugar, wheat, and pork lard, and, within a few years, they were running a diversified business that operated everything from textile mills to trading houses. By 1911, the business was so large that the family created the first conglomerate in Brazil, the Indústrias Reunidas Fábricas Matarazzo, opening up the capital to subscription by friends and other family members. The statutes were, by design, somewhat democratic, incorporating, in 1911, for example, the rule of ten shares for one vote and a maximum of fifty votes. This voting scheme restricted the top three, five, and ten shareholders, who controlled most of the equity, to 10 percent, 17 percent, and 34 percent of total votes, respectively. But the scheme lasted only a few years. By the 1920s, the Matarazzo family had bought back most of the equity held by nonfamily members and had changed the voting rights, first pulverizing share ownership by issuing thousands of small-denomination shares (10$000 or ten mil reis), then altering the statutes so that the right to vote was restricted to only those with holdings of 1:000$ (a thousand mil reis). In 1934, only four or five shareholders held enough shares to vote. From that time on, the family purchased most of the shares and held them tightly.\textsuperscript{53}

The Matarazzo family controlled a variety of businesses, including the Banco Italiano del Brasile, whose shareholder lists help to illuminate its approach to corporate governance. The bank originally had a relatively large number of shareholders from the Italian community, though the Matarazzos controlled most of the equity and shares. Then, in 1907, the family used its voting power to dissolve the bank and sell its assets to another bank that it controlled.

This model of concentrated ownership under family control, though not always the dominant model, is a typical arrangement in Brazil today. Many of the family businesses before the 1930s were relatively small enterprises, compared to railways and large banks. But, by the 1980s, family-controlled conglomerates had become the dominant corporate form. The reasons for the family firm’s eventual domination of the Brazilian corporate landscape in Brazil are beyond the scope of this paper. Yet, the fact that history shows such variation in shareholder

\textsuperscript{52} In 1891, the Matarazzo family chartered its first corporation, the Companhia Matarazzo. The main objective of this company was to process and sell pork lard in the states of São Paulo and Rio Grande do Sul. This company required 10 shares for one vote and limited the number of votes to 50. See “Cia. Matarazzo,” in Diario Oficial do Estado de São Paulo, 2 June 1891.

\textsuperscript{53} The changes made to statutes at the extraordinary shareholders’ meeting of May 29, 1926 are reported in “Decreto n. 17544–de 10 de Novembro de 1926”; and the shareholder list and voting count of the extraordinary shareholders’ meeting of October 11, 1933 are reported in “Decreto N. 2–de 25 de Julho de 1934.”
protections and corporate finance over time raises questions about the degree to which colonial institutions have determined the course of events over the long run.

**Epilogue: Major Trends in Corporate Governance after 1940.** Even if, after 1940, the law, on paper, offered more protections for small shareholders, in practice, ownership became more concentrated, and small shareholders lost control rights in large Brazilian corporations. The corporate landscape after the 1940s differed in two respects from the period I have considered. First, large corporations came to rely heavily on preferred shares to sell equity to small investors. These corporations mainly had one controlling shareholder (or a family) and hundreds, or even thousands, of small investors holding preferred (non-voting) shares. Second, the government began to participate actively in the ownership of large corporations, usually controlling the majority of voting shares.54

One might argue that the practice of preferred shares, introduced in 1932, protected small shareholders by guaranteeing a fixed cash flow. However, issuing a large part of a company’s equity in nonvoting shares allowed insiders to acquire control at a lower cost. This situation grew even worse with time, after Brazilian laws reduced the share of equity necessary to control a company in 1976, allowing companies to have up to 66 percent of capital in nonvoting shares (as opposed to just 50 percent). After the 1940s, one can observe a continuous process of systematic assumption of control by a few families and holding companies, known as grupos.

With the advent of economic nationalism during the first two regimes of Getúlio Vargas (1930–37, 1937–45), the federal government started to participate actively in the ownership of large corporations. Often, the government gave “national security” as its reason for becoming involved in a company. In other instances, the government bailed out large companies (e.g., railways and banks) in exchange for a controlling stake. After such transactions, the government usually changed the system of voting rights for shareholders in order to gain full control of the corporations. Thus, for example, in some of those bailouts, maximum-vote provisions were eliminated.

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54 In the 1930s, the cost of controlling a corporation was significantly altered with the introduction of (nonvoting) preferred shares. Decree 21,526, 15 June 1932, regulated preferred shares. By this decree there was no explicit limit as to what percentage of total equity these shares could represent. Usually preferred shares did not have voting rights (it was up to each company to decide) but instead granted their owners first rights when the company distributed dividends and/or priority when the company repurchased shares. The right to vote was sacrificed in exchange for a fixed dividend. In the case that the fixed dividend was not paid for three years, preferred shares became ordinary shares with full voting rights.
Conclusion

I have described how many large Brazilian corporations at the turn of the twentieth century induced small investors to buy equity by creating bylaws that enabled power to be distributed more democratically among shareholders. In fact, the evidence shows that maximum-vote provisions (and, to a lesser degree, graduated voting scales) were correlated with lower concentrations of ownership and voting power.

These results are surprising for at least three reasons: First, the shareholder protections in national laws that seemed to have mattered most were the ones that facilitated private monitoring of corporate activities by requiring corporations to publish important financial information. Second, my findings show that it is possible for companies to break with the institutional environment in which they operate. In the absence of national laws protecting small investors, corporations can attract small investors by adopting their own democratic bylaws. Finally, based on the evidence I have presented, it appears unlikely that the institutions relevant to the expansion of equity markets and the development of large multidivisional corporations were determined hundreds of years ago, either at the time of colonization or when countries adopted their current legal systems. The considerable variation over time at the country level, and even at the company level, needs to be studied in more detail before it is possible to make sweeping statements about the persistence of institutions, especially legal traditions.

Of course, I do not intend to argue that contracts written by companies in the form of statutes substituted for the legal system. Statutes worked to protect shareholders for two reasons: First, shareholders not only looked at statutes when deciding where to invest; they also based their decisions on the financial information published by corporations. The fact that shareholders had access to relatively good financial information was a product of the law mandating financial disclosure, and was not necessarily a consequence of voluntary disclosure. Second, statutes were binding because the court system was able either to enforce them or at least to threaten enforcement, which persuaded directors and insiders to respect company bylaws.