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Capital market governance: How do security laws affect market performance?

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Abstract

This paper examines the link between capital market governance (CMG) and several key measures of market performance. Using detailed data from individual stock exchanges, we develop a composite CMG index that captures three dimensions of security laws: the degree of earnings opacity, the enforcement of insider laws, and the effect of removing short-selling restrictions. We find that *improvements* in the CMG index are associated with *decreases* in the cost-of-equity capital (both implied and realized), *increases* in market liquidity (trading volume, market depth, and U.S. foreign investments), and *increases* in market pricing efficiency (reduced price synchronicity and IPO underpricing). The results are quite consistent across individual components of CMG and over alternative market performance measures.

JEL classification: G15; G30
Keywords: Capital market governance; Insider trading; Earnings opacity; Short-selling constraints; Market performance

1. Introduction

In an increasingly integrated global economy, interest in (and awareness of) good capital market regulation is on the rise. While presumption of the damaging effects of

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bad market governance is widespread, direct evidence on its economic consequences has been more difficult to document. Contributing to this problem is the elusive nature of governance. Because the quality of capital market governance can be associated with a number of other country-level phenomena, its direct impact on the performance of stock markets may be difficult to isolate.

In this paper, we examine how capital market regulations and their enforcement might affect a wide range of market performance measures. We focus on exchange-based (or market-related) regulations, and coin the term *capital market governance* (CMG) to describe this aspect of a country's regulatory environment. Using detailed data collected from individual exchanges for the period 1969–1998, we construct a composite CMG index that varies over time, thus reflecting inter-temporal variations in the quality of market governance in each country. We then examine the relation between changes in the CMG index and changes in market performance across countries.

Our study consists of two stages. In the first stage, we use a unique data set gleaned from market regulators, exchange officials, and industry contacts, to construct a broad index of capital market governance. Specifically, we exploit innovations developed in several recent studies to measure three dimensions of capital market governance: (1) a composite earnings opacity measure, (2) insider trading laws and their enforcement, and (3) relaxation of short-selling restrictions. Fig. 1 provides an overview of these market governance variables.

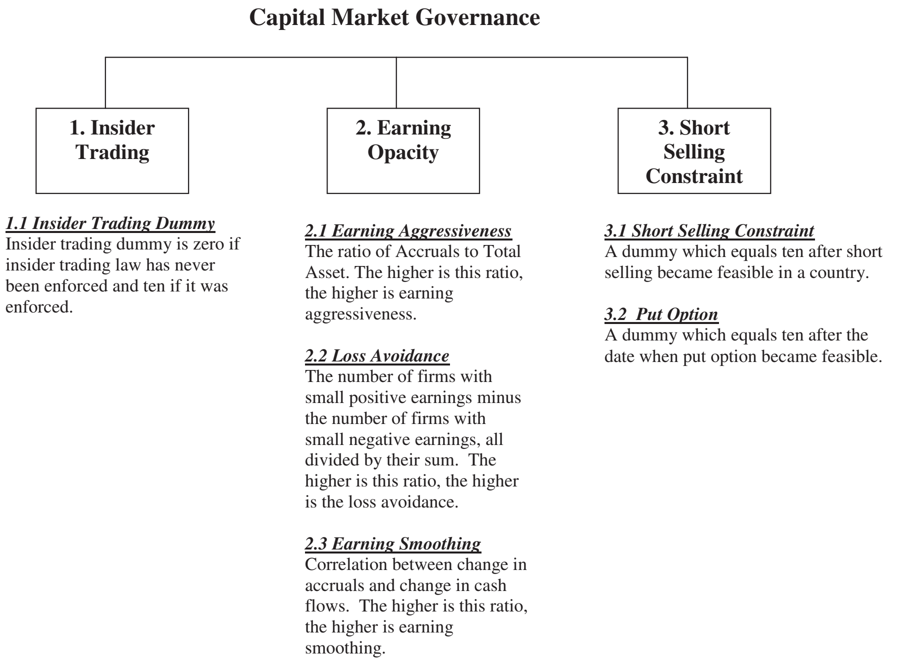

Fig. 1. Capital market governance measures.