1. A law-and-finance perspective on capital markets

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1. INTRODUCTION

The term ‘law and finance’ can be understood in a narrow or a wide sense. In a narrow sense, it refers to a line of research associated with a 1998 article by La Porta et al. entitled ‘Law and Finance’. This article, to be discussed in the next section,¹ used empirical methods in order to examine whether there is a provable link between high levels of shareholder protection and financial development. Further research aiming to show causality between ‘law’ (widely understood, including law enforcement) and ‘finance’ (again, widely understood) has been the subject of many further publications by many of the same authors – subsequently coined the ‘Law & Finance School’.²

By contrast, others understand ‘law and finance’ in a wider and more generic way, covering research and teaching that tries to combine the two elements. For example, this applies to research centres on ‘law and finance’ established at the Universities of Chicago, Frankfurt and Genoa.³ A wide approach has also been adopted in MSc or LLM programmes on ‘law and finance’ at the Universities of Oxford, Leeds and Amsterdam, as these programmes cover conventional legal topics (such as corporate law and securities law), conventional management topics (such as accounting and corporate finance) and combinations of both.⁴

In this chapter, ‘law and finance’ will be understood in an intermediate way. The chapter starts with an outline of the research by the Law & Finance School as far as it relates to capital markets. It then considers empirical research by other scholars that also aims to explore the relationship between law and capital markets, in particular research that has been more specific than the Law & Finance School in examining the causal factors of specific financial outcomes (that is, not only general capital market development).⁵ This research is similar to the Law & Finance School as it is also of a quantitative nature and interested in the causal link between law and finance. Thus, a representative selection of those studies will be included here, while this chapter will not deal with qualitative empirical research or with research on other causal questions.⁶

¹ See Section 2.1, below.
² Schnyder et al. (2021).
⁵ See Section 3, below.
⁶ For those see, e.g., Black (2010) 165–70 (in particular on the impact of securities markets on law and regulation).
The structure of this chapter is as follows. Section 2 addresses the studies, mainly but not only associated with the Law & Finance School, that explore the determinants for developed capital markets, while section 3 deals with studies linking aspects of securities law to specific financial outcomes. Section 4 concludes with a critical discussion of some common themes.

2. STUDIES ON DETERMINANTS FOR DEVELOPED CAPITAL MARKETS

The studies discussed in this section aim to explain what legal and other factors are decisive for capital market development. Further research has found that there is also a causal link between countries having a developed capital market and economic growth.\(^7\) Thus, the normative aim of this line of research is to identify ‘good law’ (that is, legal rules but also means of law enforcement). It started with a path-breaking study by La Porta et al. which mainly examined company law (see section 2.1, below), while subsequent studies turned their attention to the role of securities law (see section 2.2, below).

2.1 The Role of Company Law

Company law is not explicitly interested in capital markets; yet, a link to capital markets is plausible as far as the shares of companies are traded on stock markets. Much of company law aims to protect the position of shareholders, be it directly through shareholder participation or indirectly, for instance through directors’ duties.\(^8\) Thus, a higher level of shareholder protection could mean that there is greater willingness to invest in companies’ shares on the stock market so that, as a result, the size of the country’s capital markets grows.

The seminal 1998 paper by La Porta et al. on ‘Law and Finance’ examined this hypothesis empirically.\(^9\) In this study, La Porta et al. coded the law on shareholder protection (as well as creditor rights) across 49 countries. Their main measurement of shareholder protection was a six-variable index for ‘anti-director rights’. The variables were defined in a brief and binary way; for instance, for ‘proxy by mail allowed’ they coded as ‘one if the company law or commercial code allows shareholders to mail the proxy vote to the firm, and zero otherwise’. Aggregating the value of these variables for each country, La Porta et al. thus created a measurement of company law that they expected to account for differences in capital market development between these 49 countries.

In econometric terms, the values of the ‘anti-director rights’ index were one of the independent variables in the regression analysis that aimed to explain differences in capital market development.\(^10\) For capital market development, that is, the dependent variable, a variety of different measures can be employed. In the ‘Law and Finance’ article, La Porta et al. merely used a measure of shareholder ownership dispersion (based on the reasoning that capital

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\(^7\) The main publication is King and Levine (1993).

\(^8\) See, e.g., Pritchard (2018). This relates to the view of company law as addressing the ‘principal-agent’ relationship between shareholders and directors. To be sure, this is not the only way to conceptualise company law. For the debate see, e.g., Segrestin and Hatchuel (2011).

\(^9\) La Porta et al. (1998).

\(^10\) Other variables included the ‘legal origin’ categories; see also note 18, below.
markets are seen as more developed if they encourage diversified investment), while a companion paper used measures related to stock market capitalisation and the number of listed firms and IPOs.\(^{11}\) The result of both of these studies was that the cross-country measurements of anti-director rights were found to be a determinant for these measures of stock market development.

While La Porta et al. focused on shareholder protection and equity markets, their studies also included a variable on ‘creditor rights’. Yet, this variable, which coded four questions of insolvency law, was found to be of lesser empirical relevance. A study by Gu and Kowalewski revisited this topic, drawing on an updated version of the La Porta et al. coding of shareholder and creditor rights for 42 countries. Using the ratio of corporate bond market capitalisation to equity market capitalisation as a dependent variable, Gu and Kowalewski now also found that strong creditor rights are associated with countries that have more developed corporate bond markets than equity markets.\(^{12}\)

As regards shareholder protection, a paper by Spamann revisited La Porta et al.’s country coding on ‘anti-director rights’. Finding and correcting many coding errors, Spamann’s research could not replicate the finding that ‘anti-director rights’ are indeed a determinant of capital market development.\(^{13}\) Meanwhile, the Law & Finance School – now joined by Djankov – developed another measurement of company law. This was presented in a 2008 paper on the law and economics of self-dealing.\(^{14}\) This study circulated a complex hypothetical case of a transaction between two companies to lawyers from 72 countries, and asked them to respond to questions such as ‘which body of the companies has to approve the transaction in question?’ and ‘how could the transaction’s validity be challenged?’ Then, Djankov et al. coded this information using various indices and sub-indices. Finally, they found that this new dataset predicts stock market development, and generally works better than the initial La Porta et al. index.

By contrast, a research project based at the Centre for Business Research (CBR) of the University of Cambridge mainly reached a different empirical result as to the role of company law. Inter alia, this project developed a functional ten-variable index on shareholder protection, considering a wider range of legal topics than the Law & Finance School.\(^{15}\) It also coded the law of various legal systems across time (initially 1970 to 2005; then 1990 to 2013), which can be a means to test more precisely whether law really has a causal effect.

In one of the papers, originating from the CBR dataset, Deakin et al. found only weak evidence of a positive effect of shareholder protection on market capitalisation, the value of stock trading and the stock turnover ratio, and a negative impact on the number of listed companies. Tests for Granger causality then showed that there is stronger evidence of reverse causality, in the sense of stock market development at the country level generating changes in shareholder protection law. Thus, this paper argued that legal reforms were at least in part an endogenous

\(^{11}\) La Porta et al. (1997).
\(^{12}\) Gu and Kowalewski (2016).
\(^{13}\) Spamann (2010). There has also been extensive further literature on the shortcomings of the original La Porta et al. article: see references in Siems (2022) 236–9, 259–71.
\(^{14}\) Djankov et al. (2008). This study has subsequently been incorporated into the World Bank’s Doing Business Reports, see https://archive.doingbusiness.org/en/methodology/protecting-minority-investors.
\(^{15}\) The dataset is available at www.cbr.cam.ac.uk/datasets/.
response to stock market development and not simply a reaction to the generation of global standards or other exogenous factors.16

2.2 The Role of Securities Law

The Law & Finance School’s main paper on the role of securities law was the 2006 article by La Porta et al., ‘What Works in Securities Laws?’.17 This paper coded provisions in securities laws governing initial public offerings in 49 countries, and examined the relationship between these provisions and various measures of stock market development.

Specifically, this paper addressed securities law under the headings ‘mandatory disclosure’, ‘liability standards’ and ‘public enforcement’. The disclosure sub-index averaged the values of six variables, namely, the delivering of a prospectus, the disclosure of insiders’ compensation, the disclosure of ownership by large shareholders, the disclosure of inside ownership, the disclosure of contracts outside the normal course of business and the disclosure of transactions with related parties. With respect to the liability sub-index, the study examined whether investors could recover their losses due to misleading statements in a prospectus against the issuer, its directors, the distributor of the prospectus and the responsible accountant. Finally, the enforcement sub-index covered variables on the supervisor’s level of independence, its rule-making power, its investigative powers and non-criminal and criminal sanctions.

For stock market development, La Porta et al. used a variety of measures related to stock market capitalisation: number of listed firms, block premia, ownership concentration, ease of access to equity and value of stocks traded. In the regression analysis, results were very similar for all of those dependent variables, with the overall finding that mandatory disclosure requirements and standards of liability facilitating investor recovery of losses were strongly associated with larger stock markets. Conversely, public enforcement was observed to matter only in some specifications. La Porta et al. then also noted that ‘English legal origin’ countries (that is, common law countries) had significantly better scores in the first two categories than those of other legal origins (that is, civil law countries), which has also been a general result of most other studies of the Law & Finance School.18

The subsequent literature has been sceptical about these findings, in particular the apparent general advantage of private over public enforcement.19 The main empirical challenge was a paper by Jackson and Roe.20 By contrast to the study by La Porta et al., this paper used resource-based enforcement data, such as the staffing of securities regulators per population, and their budgets per GDP, in order to measure country differences in public enforcement. This reversed the finding of the importance of public and private enforcement, using similar dependent variables of stock market development as La Porta et al. Thus, according to Jackson and Roe, ‘public enforcement is overall as important as disclosure in explaining financial market outcomes around the world and more important than private liability rules’.21

16 Deakin et al. (2018). But see also Ahiabor et al. (2018) (using the same data and differentiating between different types of shareholder protection, finding an effect for ‘enabling’ but not ‘paternalistic’ forms of shareholder protection).
17 La Porta et al. (2006).
18 La Porta et al. (2008).
19 Initially by Coffee (2007). See also Yeung and Huang (2012).
20 Jackson and Roe (2009).
21 Ibid. at 207.
With respect to the possible role of legal families, the findings by Jackson and Roe also
differ from those by La Porta et al. They note that, according to their data, common law coun-
tries have higher levels of public enforcement resources, which is seen as counter-intuitive, as
‘civil law systems are frequently seen to regulate their economies more extensively than do
common law systems’.22 This also has implications for the question of whether there is really
a causal link between law and finance. While La Porta et al. use the legal family divide as an
instrumental variable,23 Jackson and Roe take a sceptical view, stating that it seems more likely
that there is a bidirectional relationship, ‘with strong financial markets inducing governments
to protect a key constituency and a vital market sector’.24

Further empirical research on the role of securities law has scrutinised similar topics as the
La Porta et al. study, notably the relevance of disclosure rules and law enforcement; yet, as
those studies use data on more specific financial outcomes (that is, not merely general capital
development) as dependent variables, they will be discussed in the next section.

3. STUDIES LINKING ASPECTS OF SECURITIES LAW TO
SPECIFIC FINANCIAL OUTCOMES

The studies outlined in this section aim to explain specific outcomes of securities law.25 They
are therefore typically concerned with specific legal themes, such as rules on disclosure,
insider dealing, short trading and so on, and can thus be divided into studies that use vari-
ables of securities law related to primary markets (section 3.1) and those related to secondary
markets (section 3.2).

3.1 Primary Markets

Access to most primary markets requires issuers to produce a prospectus. Yet, mandatory
disclosure is not an inevitable feature of the relevant legal rules. It can also be argued that
issuers would, in any case, have an incentive to provide information to investors in order to
attract investment. Or, from a different perspective, it may be said that reliance on disclosure
as a regulatory tool of primary markets is bound to be ineffective as investors are unlikely to
be able to evaluate this information efficiently.26

The empirical literature on this topic mainly derives from the US. Its starting point is a 1964
paper by Stigler which compared the period prior to the federal statutes on US securities law
to a later period.27 It found that the mandatory disclosure rules and the creation of the SEC did
not make a difference to stock prices. Further empirical studies have reached similar results,

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22 Ibid. at 230.
23 La Porta et al. (2006) 27. For the difficulty of proving causal links see also Section 4, below.
24 Jackson and Roe (2009) 233. See also Section 4, below.
25 Thus, this section will only deal with topics of securities law, not the extensive literature on the
effective effects of law reforms in company law: for the latter topic see, e.g., Klausner (2018); Bhagat
and Romano (2007).
26 These arguments relate to the Efficient Capital Markets Hypothesis (ECMH) as well as behav-
leading Romano to conclude that ‘there is a paucity of evidence that the federal disclosure regime administered by the SEC has benefited investors’. 28

However, some other research has pointed in a different direction. Ferrell examined a 1964 reform which imposed mandatory disclosure requirements on the over-the-counter (OTC) market, finding it to be ‘associated with both a dramatic reduction in the volatility of OTC stock returns and with OTC stocks enjoying positive abnormal returns’. 29 In other writings, Ferrell also refers to ‘empirical evidence on the effects of mandatory disclosure on stock returns, volatility and financial development’ drawing on the comparative findings by La Porta et al. and other studies. 30 Moreover, a review of studies by Mahoney concludes that the ‘empirical results largely, although not uniformly, indicate that mandated disclosure improves public companies’ valuation and liquidity’. 31

As in the La Porta et al. study on securities law (see section 2.2), research has also considered the role of enforcement. Using the La Porta et al. legal data, Hail and Leuz found that mandatory disclosure requirements and strict enforcement lower the cost of equity capital; 32 Cumming et al. specifically investigated whether there are differences according to firm size and, drawing on data from 46 countries, found that ‘public enforcement facilitates small firm security issuance, while private enforcement benefits large firms more than small firms’; 33 and a general review of the literature by Jackson and Zhang concludes that empirical results about the association between enforcement of securities law and technical measures of financial markets are mixed, also noting that this may not be ‘too surprising given that enforcement is only a piece of the regulatory framework’. 34

The possibility of cross-border listings also offers the opportunity for empirical research on the role of law in primary markets. The background of this line of research is the so-called bonding hypothesis, namely that companies from countries with low levels of investor protection seek to cross-list in a country with higher protection in order to compensate for the former law. 35 For example, an empirical study by Huang et al. investigated mainland Chinese shares cross-listed in Hong Kong, finding that these shares ‘are more liquid, have lower transaction costs and less information content in trades than those non-cross-listed’ and thus confirming the bonding hypothesis. 36

However, it is also possible that the foreign listing of companies is due to a different strategy, namely that companies’ choice of one stock exchange over another is due to their desire to opt for a laxer regime. For example, the Chinese company Alibaba deliberately decided not to list in Hong Kong but in New York since the Hong Kong Stock Exchange did not allow them to retain their dual class share structure. 37 The potentially adverse effect of strict laws has also been the subject of empirical research by Litvak on the effect of the Sarbanes–Oxley Act.

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29 Ferrell (2007a).
30 Ferrell (2007b) 126.
31 Mahoney (2021) 30. But see also the review article by Leuz and Wysocki (2016) which concludes that ‘we still (…) lack evidence’ on the effect of disclosure and reporting regulation.
33 Cumming et al. (2015).
35 E.g., Doidge et al. (2004). But see also Filatotchev et al. (2020).
36 Huang et al. (2016).
37 See Huang et al. (2018).
(SOX) on cross-listings in the US, finding that post-SOX the cross-listing premium associated with trading in the United States declined and that stock prices of cross-listed companies subject to SOX declined significantly compared to cross-listed companies not subject to SOX.\textsuperscript{38}

Recent empirical research on crowdfunding legislation has also come to the conclusion that ‘too much’ law can have a negative effect. According to a paper by Hornuf and Schwienbacher, the crowdfunding market in Germany shows that crowdfunding platforms that switched to investment forms with lower regulatory requirements (specifically: subordinated profit-participating loans) attracted more investment, which thus ‘contrasts with the traditional “law and finance” view that stronger investor protection is better’.\textsuperscript{39} In this regard, a cross-reference can also be made to empirical research that presents data on companies listed on traditional and alternative stock markets (and how these numbers change across time, with studies examining the role of admission requirements but also other determinants).\textsuperscript{40}

### 3.2 Secondary Markets

The regulation of secondary markets covers a variety of legal topics, such as insider dealing, securities fraud, ongoing disclosure obligations and rules on the trading of securities. More broadly, one may also include takeover law; yet, as the empirical research on takeover law is strongly focused on the corporate governance of the target company (and not questions of securities law),\textsuperscript{41} it will not be covered here. Likewise, the following will not address the empirical research on accounting standards.\textsuperscript{42}

The theoretical debate about insider dealing is complex\textsuperscript{43} and empirical research on this topic faces the problem that actual data can identify enforcement data on insider dealing cases\textsuperscript{44} while the true amount of insider dealing can at best only be estimated. As far as the law is concerned, country variations offer some possibility for conducting empirical research. For example, Bhattacharya and Daouk analyse the introduction of insider dealing laws in 103 countries and find that these new laws did not affect the cost of equity per se; yet, such an effect can be observed after countries launched the first prosecution on the basis of the new laws.\textsuperscript{45} Beny, by contrast, draws on an index of insider dealing laws in 31 countries, finding that these laws are associated with variables such as stock market liquidity; yet, whether this is a causal relationship is not clear.\textsuperscript{46}

A large number of studies have examined the effect of specific laws of secondary markets. For example, in the EU, the (former) Market Abuse Directive, which covers prohibitions of

\textsuperscript{38} Litvak (2007a, 2007b). But see also Doidge et al. (2009) (listing in the US still has unique governance benefits for foreign firms).

\textsuperscript{39} Hornuf and Schwienbacher (2017).

\textsuperscript{40} See, e.g., Vermeulen (2018); Rose and Solomon (2016).

\textsuperscript{41} See, e.g., Bhagat and Romano (2007) 987–92, but also Mahoney (2021) 40–2 (for studies on the US Williams Act addressing topics of securities law).

\textsuperscript{42} For an empirical example see Breuer (2021) (making use of variations in the adoption of EU directives). For a review of studies on the adoption of the International Financial Reporting Standards (IFRS) see Leuz and Wysocki (2016) 582–98.

\textsuperscript{43} See, e.g., Bainbridge (2013).

\textsuperscript{44} For an example see Perino (2020).

\textsuperscript{45} Bhattacharya and Daouk (2002).

\textsuperscript{46} Beny (2006).
insider dealing and market manipulation (for example, securities fraud), has been used as a test case in empirical research. General analyses by Cumming et al. and Christensen et al. used the staggered implementation of the Market Abuse Directive, as well as the Markets in Financial Instruments Directive (MiFID) (Cumming et al.) and Transparency Directive (Christensen et al.), in showing that implementation of these directives had increased stock market liquidity.\textsuperscript{47} Other studies dealt with more particular effects: Dubois et al. examined the effect of the implementation of the Market Abuse Directive on stock recommendations issued by brokers, finding that it had mitigated the effect of conflicts of interest on equity research;\textsuperscript{48} Cumming et al. found that differences in detected offences against the Market Abuse Directive are a result of institutional differences, such as the number of supervisors;\textsuperscript{49} and Siems and De Cesari analysed the impact of the market abuse provision on share repurchases, finding inconsistent reactions in the Member States.\textsuperscript{50} Beyond market abuse, a study on non-US firms cross-listing their shares in the US found that MiFID has led to an increase of those shares being traded in the EU,\textsuperscript{51} and a study on the 2013 amendment of the Transparency Directive found that lower quarterly reporting levels have increased information asymmetry and reduced firm value.\textsuperscript{52}

In the US context too, law reforms have been a popular subject of empirical research. Here the econometric technique has often been an event study methodology,\textsuperscript{53} namely how far a particular legal event was reflected in the stock price of affected companies. For example, two studies on the Private Securities Litigation Reform Act of 1995, which, among other things, strengthened requirements for claims of securities fraud, found a positive stock market effect (whereby these two studies identified the companies from industries that were regarded as particularly likely to be affected by securities litigation).\textsuperscript{54} There has also been research on the impact of the Regulation Fair Disclosure 2000 (RFD) and the SOX, with some studies using the limited application of rules in specific market segments as a means of causal identification.\textsuperscript{55}

The final examples to mention are studies on the effect of bans on ‘short selling’. These bans often occur in times of crisis. A number of studies have thus looked at the short-selling bans imposed during the Global Financial Crisis of 2008, with inconsistent findings as to whether these bans can successfully tackle bubbles or crashes or else hinder transactions that improve

\textsuperscript{47} Cumming et al. (2011); Christensen et al. (2016). See also Bremus and Kliatskova (2020) (EU legal harmonisation has fostered cross-border portfolio equity investment).
\textsuperscript{48} Dubois et al. (2014).
\textsuperscript{49} Cumming, Groh and Johan (2018). Another question is how markets react to the strength of enforcement, see Olsen (2021) (examining enforcement differences of the subsequent EU Market Abuse Regulation).
\textsuperscript{50} Siems and De Cesari (2012).
\textsuperscript{51} Cumming, Hou and Wou (2018); also Anlolick et al. (2021) (analysis of impact of MiFID on share repurchases).
\textsuperscript{52} Behrmann et al. (2021). By contrast, Kajüter et al. (2019) find that the introduction of mandatory quarterly reporting in Singapore had a largely negative effect.
\textsuperscript{53} See generally Bhagat and Romano (2007) 948–51.
\textsuperscript{54} Spiess and Tkac (1997); Johnson et al. (2000). For further empirical US research on the effects of litigation on equity issuance decisions, firms’ cost of capital, financial reporting and corporate governance see the literature review by Arena and Ferris (2017). Data on US securities class action filings and settlements are available at https://securities.stanford.edu/.
\textsuperscript{55} See Christensen et al. (2016) 2889. For a review of further studies on the effect of RFD and SOX see Leuz and Wysocki (2016) 560–71.
market quality.\textsuperscript{56} In the COVID-19 crisis, some European countries imposed temporary short-selling bans; yet here too, it is not clear whether this policy has been effective.\textsuperscript{57}

4. DISCUSSION AND CONCLUSION

The research outlined in this chapter covers a variety of topics and uses a variety of methods. Yet, it is also possible to identify and discuss the following common themes.

First, most of the studies discussed here have found that law matters for both capital market development and specific financial outcomes. This may be in line with non-quantitative legal research, as it also explores ‘the legal and institutional preconditions for strong securities markets’.\textsuperscript{58} Yet, the studies which did not find the law to have a positive effect also deserve attention. Recent years have seen claims about publication bias and replication crisis in scientific research, inter alia due to the tendency to only publish research with significant results.\textsuperscript{59} Thus, it is perhaps no surprise that most studies that examine the effects of law indeed find that ‘law matters’, while some of these causal claims have subsequently been shown to be incorrect.\textsuperscript{60} From a policy perspective, such a bias for positive results also means that there may be a risk of academic studies suggesting an overreliance on law as a means of influencing securities markets. This does not necessarily mean that these studies have influenced lawmakers in a particular manner; yet, there is also some evidence that – through the World Bank’s Doing Business Reports – the studies of the Law & Finance School did have a real-world influence in many parts of the world.\textsuperscript{61}

Second, the ‘law’ of the studies discussed in this chapter is typically legislation. This makes claims in the La Porta et al. studies about deep conceptual differences between common and civil law countries doubtful. For example, Gelter writes about US securities law that ‘it does not look like common law at all, but almost like a caricature of civil law legislation’.\textsuperscript{62} Securities law in many countries has also been heavily influenced by legal transplants: from the US to European countries, from the UK to the EU, from the US and Europe to Japan and China, and so on. Of course, this does not mean that these laws are enforced in a similar way: thus, it is valuable that some of the research discussed here has examined the role of public and private enforcement. Yet, it is also suggested that this topic is still underexplored; for example, future research could compile comparative data on enforcement akin to the recently published Comparative Competition Enforcement Dataset.\textsuperscript{63}

\textsuperscript{57} Siciliano and Ventoruzzo (2020).
\textsuperscript{58} Black (2001).
\textsuperscript{59} For the discussion see, e.g., ‘Reproducibility of Scientific Results’ (3 December 2018), at https://plato.stanford.edu/entries/scientific-reproducibility.
\textsuperscript{60} See Section 2.1, above.
\textsuperscript{62} Gelter (2019) 9.
\textsuperscript{63} See https://comparativecompetitionlaw.org/data/.
Third, the actual legal information of the studies is typically based on either an index that measures certain legal topics or simply the enactment of a particular law. Beyond the Law & Finance School, the trend goes in the latter direction. Examining the effect of a particular law seems straightforward, and it is also in line with the growth of interest in impact assessment. Yet, the limitation is that any such findings may have low external validity; in other words, the effect of a particular law reform strengthening or loosening investor protection may not be generalisable to a different country or a different time period in the same country. Thus, index construction and coding of legal rules also have some merits. Yet, such research needs to learn the lessons from the shortcomings of the La Porta et al. studies, such as biases in the choice of variables and coding errors, but also the fundamental problem that any index claiming validity at a global scale needs to be sensitive to the way similar (or different) legal rules work in different local contexts.

Fourth, a key issue is whether the research discussed here can identify robust causal relationships between law and finance. Details of econometrics are beyond the scope of this chapter; yet, two aspects should be mentioned. On the one hand, the studies discussed here often face the challenge of omitted variables. The functioning of capital markets depends on a variety of tangible factors, such as qualified personnel and modern technology, but also less tangible ones such as informal institutions, culture and customs, and so on. Ideally, regression analysis would control for all of these topics; yet, how far this is feasible is not clear. On the other hand, it is a major problem of the research on law and finance that law is endogenous to society; in particular, it cannot be assumed that law is exogenous to capital markets since market developments often cause legal reform. For studies that use data from various jurisdictions, it is also difficult to identify a valid ‘instrumental variable’ that could address this concern. Studies on the effect of specific laws can equally be problematic as there is often no precise control group, in order to exclude the possibility that the apparent effect is not only due to general changes in market conditions.

Fifth, a further shortcoming of the studies discussed here is that they cannot show us precisely how law influences behaviour – and thus why any (alleged or real) changes in capital markets take place. To be sure, identifying this missing link is not easy. As Friedman rightly points out, the way law affects behaviour is a cross-disciplinary topic that should draw on extensive research in political science, sociology, economics, criminology, law and psychology. It may also necessitate the use of qualitative fieldwork or even anthropological research; yet, such research is rare in the field of securities law and capital markets. In addition, some quantitative measures exist that enable researchers to consider not only the positive law but also the perceptions of the law: thus, it is suggested that future research should aim to make use of these (and other) attitudinal and behaviour data in order to foster our understanding of the relationship between law and finance.

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64 See, e.g., Petrin (2016).
65 See Section 2.1, above, as well as Siems (2005).
66 This has been shown in a number of studies, such as Gerner-Beuerle (2007); Cheffins (2008); Coffee (2002).
67 See Section 2.2, above.
69 Friedman (2016).
70 For examples see Larson (2004); Riles (2013); Nowak (2022).
71 For a contribution to this line of research see Schnyder et al. (2022).
To conclude, the past three decades have seen a large number of studies in the field of law and finance, not only by the so-called Law & Finance School but also by other researchers. Most of this research derives from business schools or departments of economics or management. Yet, it is suggested that legal scholars should also take part in this debate, as they can provide important insights into laws worth testing for their empirical effects.

BIBLIOGRAPHY


