

How Does Law Affect Finance? An Examination of Financial Tunneling in an Emerging Market

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Abstract:

We establish that one channel through which law affects financial markets is by control of financial tunneling. We first develop a model of how legal rules affect two common forms of financial tunneling: dilutive equity offerings and below-market freezeouts, and how these forms affect equity valuations. We then report evidence from Bulgaria, which goes through mass privatization in 1998, followed by extensive post-privatization tunneling. In 2002, Bulgaria adopts securities law changes which rescue a collapsing market by limiting both forms of tunneling, and provide a natural experiment which allows us to test the model predictions. Following the legal changes, minority shareholders participate equally in secondary equity offers, where before they rarely participated and suffered severe dilution; and freezeout prices quadruple (measured as offer price/sales). After the law is adopted, valuation measures (price/earnings, price/sales, and Tobin's q) more than double for firms at high risk of tunneling, relative to lower risk firms. We thus present evidence from an emerging market on (i) the importance of legal rules that limit financial tunneling, and (ii) the importance of financial tunneling risk as a factor in determining equity prices.

Keywords: law and finance, financial tunneling, freeze-out

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