

# Protecting Your Investments May 2009

## Corporate Governance in Brazil

By José Luiz Osorio

Good Morning to all and thank you for inviting me to speak about such a relevant subject where Brazil has very interesting examples, both good and bad.

My presentation will address four main topics. First, I will describe Brazil's existing investor protection legislation. Second, I will discuss recent important developments in corporate governance. Thirdly, I will highlight certain important issues currently under discussion as part of a programmed review of governance practices. Fourth, I will try to answer, perhaps the most important question for investors: "Has better governance paid off in Brazil?" Finally, I will make my concluding remarks before opening for questions.

### **Brazil's investment landscape**

Between the years of 1994 and 2000, whilst significant progress had been made in stabilizing the economy and controlling inflation, the Brazilian equity market remained trapped in a vicious circle of poor corporate governance, weak enforcement, scant minority investor protection, shallow liquidity and low valuations, that led to a spate of de-listings and to companies migrating to the NYSE. Contrast this state of affairs with the record number of IPOs that came to market between 2004 and 2007, raising a total of US\$ 45 billion from foreign and domestic investors, and it is inevitable to ask: what changed?

In 2001 the existing investor protection legislation, corporate law 6404 and 6385 of 1976 were both reformed improving, among other things shareholders rights, enforcement and, turning the CVM into an independent agency.<sup>1</sup>

Around the same time Bovespa (São Paulo stock exchange) created three new listing levels for issuing companies, each with increasing corporate governance requirements, all voluntary. The principal practices required of each level are described below<sup>2</sup>:

- **Level I** requires the improvement in quarterly reports, including the disclosure of consolidated financial statements and special audit revision, monthly disclosure of trades involving equities issued by the company on the part of the controlling shareholders.
- **Level II** requires companies to present their results in accordance with US or international GAAP, in addition to Brazilian GAAP, tag along rights, 80%, for non voting shares, arbitration for shareholders' disputes, vote by non controlling shareholders on transactions between related parties and a two-year unified

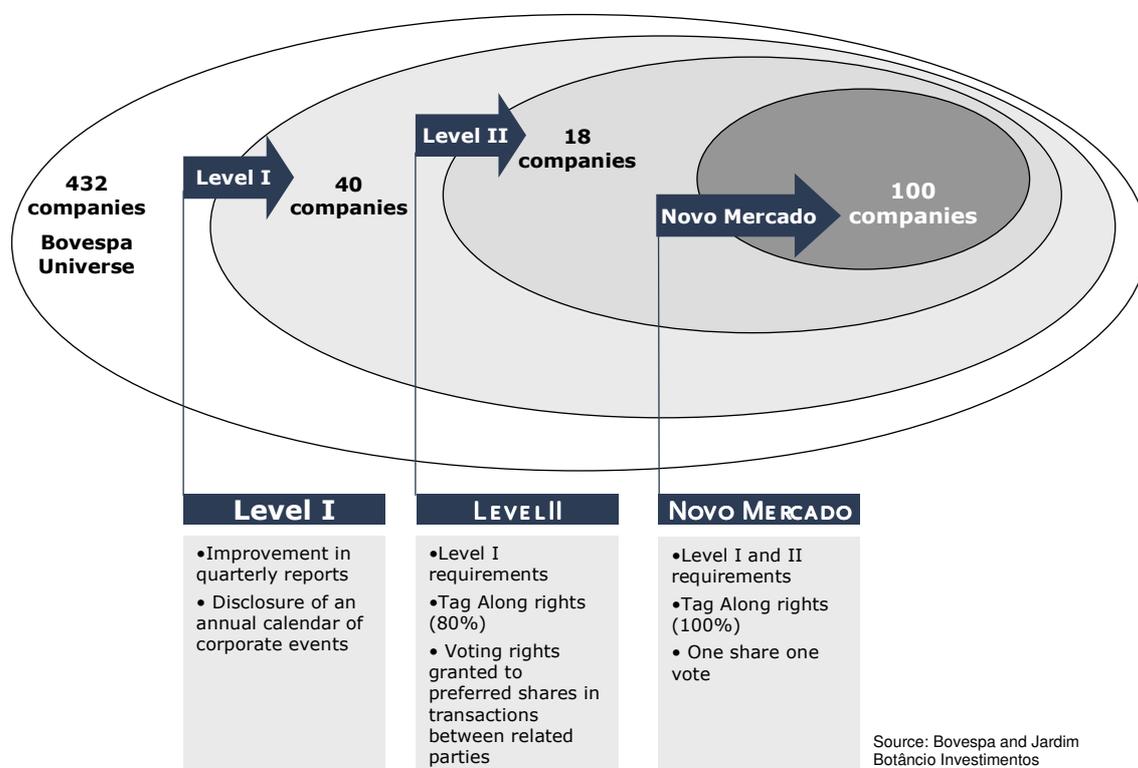
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<sup>1</sup> For further information please visit the CVM's link <http://www.cvm.gov.br/ingl/indexing.asp>

<sup>2</sup> For more details, please see: <http://www.bovespa.com.br/indexi.asp>

mandate for the board directors with five members, of which, at least, 20% independent.

- **Novo Mercado** respects all the rules for Level I and II, and also includes one share one vote and 100% of tag along, as mandatory.



Data shown later on this presentation substantiates that these micro improvements, as well as better macro economic fundamentals, provided the basis for a very active capital markets in the last five years.

### Recent Important Developments

CVM has continued to issue new important rulings (Instruções Normativas) and guidelines (Parecer de Orientações) aimed at further improving investor protection and transparency. Some of the most important are listed below.

#### Better enforcement against Insider Trading

In 2005, the CVM signed an agreement with the Public Prosecutors' Office that makes it possible to freeze assets in cases involving allegations of insider trading.

#### Convergence of Brazilian GAAP accounting to IFRS

Beginning as a recommendation for the 2008 Financials, the CVM announced a schedule for harmonization with the international accounting standards (IFRS accounting), as per law 11.638/2007. The Committee for Accounting Pronouncements (CPC) has already issued 17 deliberations and it is expected to announce others until the end of the year. In 2009 Brazilian companies will be required to apply the standards issued in 2008. The other pronouncements will be mandatory for the first quarter of 2010, which by then Brazilian companies will be reporting 100% under IFRS standards.

Brazil is the first country to adopt the IFRS both in consolidated balance sheets of corporate groups and of individual companies. In Europe, IFRS is only mandatory for consolidated financial statements.

#### Possibility of on line voting

Historically, investors, active or not, had a very difficult time to participate in shareholders meetings. Not only the paper work required for registration was cumbersome but the concentration of several meetings within a few days made it almost impossible and very expensive to participate.

In 2008, CVM issued an official opinion # 257/2008 (Jul. 2008) encouraging a larger number of shareholders to attend general meetings. It made possible for companies to accept investor's participation on line.<sup>3</sup> While it is too soon to measure its impact, it was a move in the right direction. Active investors will have their participation facilitated and investors, in general, will no longer have an excuse not to participate.

#### CVM guideline # 35 on mergers between companies with the same controlling shareholder (Parecer de Orientação # 35)

Mergers and acquisitions, in Brazil, have commonly generated a series of questions regarding the treatment of minority shareholders. The main conflict arises from deals involving parent companies and their subsidiaries or from companies under common control, based on the fact that it lacks two distinct majority shareholding groups, separately deliberating in favor of each entity. In these cases, there are considerable chances of not reaching a fair and balanced negotiating condition, as the interest of the controlling shareholder can be contrary to that of one group of minority shareholders.

Aware of this situation, CVM issued a formal legal opinion (PO # 35/08) stating that administrators of publically traded companies should observe certain procedures regarding their companies' interests and those of its shareholders (as a whole), assuring the basis of a fair exchange relation, thus abiding with their fiduciary obligations under Brazilian Corporate Law.

The PO # 35/08 recommends the creation of a special independent committee to negotiate the deal and submit recommendations to the respective board of administration or, alternatively, the deal should be subject to approval by non-controlling shareholders, including non-voting shares and shares with voting restrictions.

This is an important step towards achieving a more balanced treatment of shareholders and a more responsible attitude by administrators.

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<sup>3</sup> In order to participate, shareholders must sign up at a specific website that provides the service. After the documentation is sent by regular mail, they receive an e-mail with a password and also their certification - which serves as a digital signature. With it, they may consult all documents pertinent to the meeting and send in their votes, which must arrive at least one day before the event.

## Under discussion

### Programmed review of Novo Mercado (NM) rules

The aim of the new regulations and rules under discussion is to promote necessary changes on the Novo Mercado based on seven years of experience and to respond to corporate-governance questions after the onset of the financial crisis

In November of last year, BOVESPA created a committee, headed by a former head of CVM, to conduct a review of the NM and consult market participants about proposals to improve it<sup>4</sup>. Important points under review are:

### Poison Pills

In principle, the “benign” purpose of introducing poison pills on the bylaws of many NM companies was to protect the company from a hostile takeover at prices that were too low, and to allow reluctant owners to go public as even with a small percentage of total capital they could maintain control of their companies. With hindsight it is clear that this artifice went beyond its original objectives.

The committee may propose some alternatives such as: an expiration period, when after x years, the poison pill clause should be reassessed in a shareholders’ meeting or just cease to exist. Other proposal suggests that bylaws always permit that any clause, particularly poison pills may be changed by shareholders vote.

### Board Member Participation

The proposal is to improve the quality of board members’ work. The NM committee will probably recommend that the percentage of independent members on the board should be raised to 30%. It is also concerned with board member’s time dedication. There is a concern with the number of boards that each member participates at the same time. Instead of establishing a maximum number of Board participation the committee will probably defend more transparency and that companies should disclose their directors' profiles, with information such as primary occupation, meeting attendance rates, and a listing of other company boards and committees on which they sit.

### Corporate restructurings - Tag Along Rights

Another market demand concerns defining situations where there is a transfer of control and, consequently, a public offering to all shareholders. Stock mergers do not trigger tag along rights. As we have more companies with non-defined control, NM rules may set a minimum percentage of the capital that would trigger tag along rights.

It may also recommend 100% tag along rights for PN shares on Level II.

### Among the rulings being updated by CVM, it is worth highlighting the review of CVM Ruling 202

This instruction deals with the registration of companies for issuing securities and exchange negotiations. The new instruction 202 proposes many changes concerning the release of information. The objective is to strengthen the responsibility of directors in relation to the truthfulness and completeness of the information supplied. In a few words, some of the points proposed are:

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<sup>4</sup> This study which should present its proposals to the board of BM&FBovespa shortly will need approval of at least 67% of the participants to become effective.

- **Reference Form** – The objective is to improve the quality of information presented to the market. The existing IAN (Formulário de Informações Anuais) would be substituted by the Iosco<sup>5</sup> model, called shelf registration system. The Reference Form will consolidate all information about the issuer, such as risk factors, financial data, management’s comments, operations with related parties, and capital structure. In general terms, the topics included in the Reference Form are much more detailed than they were in the IAN.
  - Remuneration of Directors and Board Members: A questionable point in the Reference Form is the disclosure of Directors and Board Members Remuneration. Currently, the CVM only requires the disclosure of the total amount, without the breakdown into fixed and variable parts. The debate around the new text is whether the details should go to the level of each individual or stay at the board and executives’ salaries.
  
- **BDRs** – According to the new rules, companies based in Brazil and companies whose revenues, generated in Brazil, represent 50% or more of gross revenues will not be considered foreign issuers. This measure will be a hindrance to companies that operate in Brazil and prefer to list themselves as foreign just to avoid CVM supervision. Nowadays, the only requirement to issue BDRs is to establish an office outside Brazil.

#### Draft for consultation #2/2009

Last month, the CVM issued a draft instruction for public consultation (# 2/2009), aimed at increasing and facilitating shareholder participation at general meetings. Two key proposals are being put forward: (i) the requirement that detailed proxy statements should be made available sufficiently in advance disclosing all matters to be voted on; and (ii) the easing of bureaucratic procedures to grant powers of attorney, that would reduce the cost of minority participation.

Under the proposal, shareholders with at least 0.5% of the capital of the company would be able to indicate candidates to the Board and the Fiscal Committee. The CVM is proposing that these minority shareholders should be able to make their indications through an online service. In the absence of such a service, certain costs incurred by shareholders should be met by the company.

#### **How has Bovespa’s Novo Mercado performed?**

Measured in terms of the number of new companies that accessed the equity market and the volume of money raised, the success of the Novo Mercado is unquestionable. It is also indisputable that NM companies have better governance standards than those in the traditional market.

Since 2004 there have been over 168 issues from 115 different companies raising over R\$160 billion, approximately US\$82 billion. From 1995 to 2003 there were 5 IPOs, compared to 7 in 2004, 9 in 2005, 26 in 2006, 64 in 2007 and 4 in 2008. During this period, the total raised through these IPOs amounted to US\$ 45 billion. In 2007, Brazil was the 3rd biggest market for IPOs globally.

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<sup>5</sup> International Organization of Securities Commissions

Out of the 110 IPOs, all but 16 companies were listed on either Level II or Novo Mercado. Nevertheless, most issues on the traditional or Level I market included additional rights such as tag along for non voting shares. Liquidity has improved from an average daily volume of US\$410 million in 2000 to approximately US\$ 2.0 billion at present.<sup>6</sup> Bovespa itself was listed and merged with the futures exchange to become the third or fourth largest exchange in the world. Except for a handful of the IPOs, all of them were made exclusively at the Bovespa with no ADRs at the NYSE.

However, did better governance in Brazil lead to better performance? Looking at the graph below it looks like the answer is not clear. First, I would like to point out some factors; most NM companies were bought by foreign investors, who liquidated their positions to raise liquidity since the onset of the crisis. Second, I will take into consideration the time period and Ibovespa's theoretical portfolio. The first one shows that the performance of an index depends on the time period chosen. The two graphs illustrate different realities, in short: if we look to five, six years back, IGC performed better than Ibovespa, but since the crisis has started the opposite has happened. Another aspect is that Petrobras' shares have the highest weight in the Ibovespa. These elements suggest that indices are not, in this instance, a good way to measure performance.



<sup>6</sup> Source: Bovespa and Jardim Botânico Investimentos.



Clearly, a company does not become more valuable just because it has listed its shares in the NM. But it is also clear that by choosing the NM, a company is voluntarily embracing higher governance standards than those in the traditional market. This should give investors more comfort and, all things being equal, be reflected in higher long term valuations.

## Conclusion

What is next on corporate governance and investor protection in Brazil? What needs to be done?

Could recent losses with derivatives by some companies in Brazil have been anticipated or avoided?

Are the challenges of re-regulation and deleveraging, that are currently high on the political agendas of many developed countries, likely to become an issue in Brazil?

What is the future of investor activism in Brazil? Will Brazilian activism ever be the same as the Anglo-Saxon model?

First, leverage and lack of regulation are not big issues in Brazil. Broadly speaking, Brazilian companies are not leveraged, the financial system is sound and (as I have shown) there has been plenty of regulation activity in Brazil. Enforcement of these regulations is always critical and there is room for improvement.

As for losses in derivatives I am not sure if there is something that can be avoided by regulation or other types of *ex-ante* investor protection. Better transparency on reporting this type of risk helps each investor to gauge his own appetite for risk. However, there is no such thing as “risk free” and financial innovation invariably brings with it a good measure of unknown or unquantifiable risks.

The nature of the Brazilian market (majority companies with defined control) makes it very unlikely that the Anglo-Saxon model of activism will ever be applied without there being a strong reaction from controlling shareholders, corporate managers, the government and other interested parties. However, that is not to say that investing in governance, discipline and activism is not important to help protect investments in Brazil. Each investor has to know what is necessary to build his own “margin of safety” and this could come from a combination of factors such as fundamental value analyses, good diversification and diligent monitoring of portfolio investments. An activism of cooperation and persuasion with the controlling group is a better definition of the Brazilian activism rather than the Anglo-Saxon model.

To sum up, I would paraphrase a famous US President: “Don’t ask what the law and the exchange can do for you, but what you can do to protect your investments.”

Thank you!

- José Luiz Osorio