

## Regional round up

### Corporate Governance: Lessons from Brazil

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#### Brazil's investment landscape

Between the years of 1994 and 2000, and while significant progress had been made in stabilising 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. This led to a spate of delistings and to companies migrating to the New York Stock Exchange. Contrast this state of affairs with the record number of IPOs (111) that came to market between 2004 and 2009, raising a total of US\$49 billion from foreign and domestic investors (including follow-on of US\$90), and it is inevitable that you ask 'what changed'?

In 2001, the existing investor protection legislation, corporate laws 6404 and 6385 of 1976, were both reformed, improving – amongst other things – shareholder rights, enforcement and turning the Comissão de Valores Mobiliários (CVM – the securities and exchange commission of Brazil) into an independent agency.

Around the same time, Bovespa (the São Paulo Stock Exchange) created three new voluntary listing levels for issuing companies, each with increasing corporate governance requirements, known as the Novo Mercado (NM). These micro-improvements, as well as better macroeconomic fundamentals, provided the basis for a very active capital market over the last five years.

#### The importance of keeping momentum

CVM has continued to issue new rulings and guidelines aimed at further improving investor protection and transparency. Some of the most important are listed below.

##### Better enforcement against insider trading

In 2005, 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 with IFRS

This began as a recommendation for the 2008 Financials, when the CVM announced a schedule for harmonisation with the international accounting standards (IFRS accounting). 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, when Brazilian companies will be required to fully comply with IFRS.

##### Possibility of online voting

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

In 2008, the CVM issued an official opinion (257/2008) encouraging a larger number of shareholders to attend general meetings. It also made it possible for companies to accept investors' participation online. Active investors will have their participation facilitated and investors, in general, will no longer have an excuse not to participate.

##### CVM's Public Consultation 2/2009

In April, the CVM issued a draft instruction for public consultation (2/2009) aimed at further increasing shareholder activism.

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. 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.

#### Review of Novo Mercado rules

The aim of this review is to promote necessary changes on the Novo Mercado after seven years of experience, and to respond to a number of corporate-governance related issues.

For the sake of this discussion, it is worth separating the proposed improvements into two categories. First, there are those that can almost be treated as 'non-events', such as granting 100% tag along rights for PN shares on Level II of the Novo Mercado and prohibiting companies with



50% or more of gross revenues from issuing BDRs listing themselves as foreign purely to avoid CVM supervision.

Second – and more challenging – is the regulation of corporate restructurings. There is a need to clearly define the situations where a transfer of control would trigger a public offering to all shareholders at the same price, bearing in mind that all-stock mergers do not trigger tag-along rights. Additionally, some NM mergers have been structured in a way that controlling shareholders end up receiving a greater price for their stock. This goes directly against the basic principle of the NM – which is predicated on one share, one vote, one price.

### How has 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.

Out of the 111 IPOs between 2004 and 2009, 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\$ 2.2 billion at present. 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.

Did better governance in Brazil lead to better performance? As usual, an analysis of the recent performance of different stock indices in Brazil fails to adequately answer this question. Clearly, longer periods of observation would be necessary to really gauge the impact of better governance.

A company does not become more valuable just because it has listed its shares in the NM. Even so, it is also evident 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.

### Lessons from Brazil

There are still many questions that need to be answered.

What are the main lessons from Brazil's experience, and what is next for corporate governance and investor protection in Brazil? 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 – and 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 has been shown) there has been plenty of regulation activity in Brazil, by CVM as well as BMF & Bovespa. Enforcement of these regulations is always critical and there is room for improvement.

The main lesson, perhaps, is that the partnership between the public policy makers and the Exchange must work continuously to improve regulations and market practices. However, there is no such thing as risk-free investment regulation or perfect governance and financial innovation invariably brings with it a good measure of unknown or unquantifiable risks.

The other important lesson is activism, which did not exist 15 or even 10 years ago. 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. In Brazil, a form of activism based on cooperation and persuasion has proven to be more effective when dealing with clearly defined controlling groups, which are more prevalent among Brazilian companies. This is also true in countries where corporate ownership is highly concentrated.