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**Case study on corporate governance disclosure in Brazil**

**Report by the UNCTAD secretariat**

**Executive Summary**

The nineteenth session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR), which took place in Geneva from 25 to 27 September 2002, requested that field cases studies be conducted in the area of transparency and disclosure requirements in corporate governance. Accordingly, five country case studies were conducted focusing on major issues in implementing corporate governance disclosure requirements. The countries on which the case studies were conducted are Brazil, France, Kenya, the Russian Federation and the United States of America.

This report presents findings of a case study on corporate governance disclosure requirements in Brazil. It provides an overview of the Brazilian capital market and the roles played by the public sector as well as the private sector in promoting improved transparency and disclosure on corporate governance. The report reviews legislation such as the Brazilian securities market law, rules and regulations of the Securities Commission and promulgation of accounting standards. The reporting requirements of the São Paulo Stock Exchange and the roles of the National Association of Capital Market Investors, the Brazilian Institute of Corporate Governance and the National Association of Investment Banks in promoting improved transparency and disclosure are also discussed. Transparency and disclosure requirements that the nineteenth session of ISAR discussed are used in this case study as reference points.

The main objectives of the study are to draw lessons from the Brazilian experience in promoting improved transparency and disclosure in the corporate sector, and to share the findings with member States that wish to strengthen transparency and disclosure in their respective markets.

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## INTRODUCTION

1. Government and regulators in Brazil recognize that corporate governance is one of the main factors holding back the development of Brazil's capital markets and are keenly aware of the link between the size and health of capital markets, the cost of capital and overall macroeconomic growth.<sup>1</sup> As a consequence, a number of initiatives have been launched, some of them quite innovative, in order to enhance the governance of companies. Brazil continues to work on legislative and regulatory reforms, as well as on the use of voluntary market mechanisms to encourage companies to improve their governance; this makes the country an interesting case study.

2. The Brazilian capital market represents some 60 per cent of the total trading volume in Latin America. Some 550 companies are listed on the Bolsa de Valores de São Paulo, or the São Paulo Stock Exchange (BOVESPA), although only about 100 to 150 companies are suitable for investment.<sup>2</sup> While figures have fluctuated considerably over the years,<sup>3</sup> the total capitalization of the Brazilian market is approximately 400 billion Reals or US\$ 140 billion.<sup>4</sup> In 2002, foreign investors made up 22.4 per cent of the shares traded on the exchange (figures have exceeded 35 per cent in the past) – 29.4 per cent were institutional investors, 22.5 per cent individuals and 21.3 per cent financial institutions.

3. The Brazilian market has some unique features that define the governance of its companies. In some countries, most typically those with an Anglo-American market tradition, ownership of publicly traded companies is dispersed and the governance dynamic tends to revolve about the separation of ownership and control.<sup>5</sup> In these countries, discussions on how to improve governance inevitably focus on how to better align the interests of owners and professional managers. Disclosure is considered one of the most important tools for exercising oversight over management.

4. In Brazil, as in the majority of other countries, ownership is concentrated. Most Brazilian companies are controlled by dominant groups (often families who fulfil the role of owners as well as managers) and the alignment of owner and managerial interests is a given. Ownership structures in Brazil therefore have more in common with companies in certain continental European countries than with countries of the Anglo-American tradition. While disclosure remains a valuable tool for exercising oversight, discussions on how to improve governance in Brazil tend to focus on how to avoid abuse by controlling shareholders and the expropriation of minority shareholders.

5. Concentrated ownership in Brazilian companies is the result of history and legal tradition. Ownership concentration was encouraged by the Corporate Law, which until recently allowed companies to issue non-voting shares, referred to as "preferred shares," of up to two thirds of a company's capital. This rule effectively allowed owners to broaden the shareholder base while maintaining control of the company. As a result of recent changes to the corporate law, the percentage of non-voting preferred shares that a company may issue was raised to 50 per cent.<sup>6</sup> The vast majority of shares on the open market are preferred non-voting shares that tend to trade at a discount compared with voting shares with control rights.

6. Arguably more important than the two share classes in maintaining control over Brazilian enterprises is the use of pyramid structures. Pyramid structures are used in more than half of Brazilian enterprises to dramatically leverage control. A number of large Brazilian firms are fully controlled by owners who hold as little as 8 per cent to 10 per cent of their capital.<sup>7</sup> Pyramid structures generally obscure the true control structure of an enterprise and often distort the relationship between control and ownership.<sup>8</sup>

7. Changes to the legal framework in Brazil are complex and difficult to achieve. A number of attempts were made to increase the free float of Brazilian enterprises and enhance the attractiveness of the Brazilian markets. Most notably, an attempt was made in the early 1990s by the Comissão de Valores Mobiliários (CVM), or the Brazilian Securities Commission, to amend the Corporate Law by reducing the percentage of preferred non-voting shares that companies are allowed to issue from two thirds to 50 per cent of the capital stock. While this amendment was finally introduced into law, the original bill was suppressed owing to strong corporate opposition and its passage did not occur until almost ten years later.

8. While desirable from the point of view of proponents of a more active securities markets, controlling shareholders are, understandably, opposed to changes that would reduce their capacity to run companies as they see fit. The failure of the CVM bill illustrates the enormous effort required to make substantive changes to Brazilian law. It also explains to a considerable extent the alternative approach pursued by the CVM and BOVESPA, which relies on the promise of a reduced cost of capital for companies that voluntarily comply with better governance practices. Whether the incentives provided to companies by a reduced cost of capital will outweigh the private benefits that can be extracted by controlling shareholders will be one of the key findings of the Brazilian experiment.

9. Concentrated ownership in Brazil is also due to the Government's privatization strategy. Brazilian privatization did not set aside shares for distribution to the public as occurred in France, Spain and the United Kingdom, where discounted shares were reserved for public purchase. In Brazil, pension funds, banks and other institutional investors bid for controlling blocks of State-owned companies. The result has been the creation of investor groups that are typically governed by shareholder agreements. Some investment holding companies were created in Brazil for the sole purpose of taking advantage of the tax write-offs of goodwill resulting from acquisitions. More pernicious cases occurred in which holding companies were used to dilute minority shareholder interests. The CVM has had to intervene in these cases, with mixed results.

10. Another important feature of Brazilian governance is the two-tiered board. As in most countries, the general assembly of shareholders is the highest decision-making body of the company. It is responsible for nominating and approving the Conselho de Administração or Administrative Council, which corresponds to the board of directors under a unitary board system. The Administrative Council determines the basic guidelines and policies of the company, establishes its strategy and reviews business plans among other things. Up to two thirds of the Administrative Council may perform executive functions. The Administrative Council, in turn, appoints the Diretoria or the executive board and the independent auditor. The Diretoria is responsible for day-to-day management and for the implementation of the broad directions established by the Administrative Council. Its members are vested with the exclusive power to act on behalf of the company.<sup>9</sup>

11. This structure is complemented by the Conselhos Fiscais or Fiscal Councils.<sup>10</sup> Brazilian Fiscal Councils are intended to provide an oversight function. They have no decision-making powers, but may review managerial decisions from a legal perspective and verify managerial compliance with company by-laws.<sup>11</sup> One seat on the Conselho Fiscal is typically granted to preferred shareholders and another to minority shareholders holding more than 10 per cent of ordinary shares. The Conselhos are composed of at least three and not more than five members to be elected at the general assembly. They serve a one-year term after which they can be re-elected. Members may or may not be shareholders and there is no explicit requirement for independence. Only a person who is a university graduate and has held a

position of corporate officer or has been a member of a Conselho Fiscal for at least three years may be elected. A requirement for legal residence in Brazil was recently dropped.<sup>12</sup>

12. The principal factors driving better disclosure are a combination of domestic and external forces. As in other countries, broad support for governance reform, whether through legislation or otherwise, often comes as a result of broadly publicized company failures. In Brazil, cases of accounting fraud have sparked greater interest in governance and transparency. In response, a number of initiatives were introduced in the Congress, including legislation to enhance disclosure and force companies to give more rights to minority shareholders. External influences are primarily the listing requirements for Brazilian companies on foreign exchanges and the demands of foreign investment funds. This case study focuses on developments that have occurred within the past two years.

## **I. The public sector**

### **A. Legislation**

13. The principal laws that establish and regulate the functioning of the Brazilian securities market are Law 6,385 as amended (the Securities Market Law) and Law 6,404 (the Corporate Law). The Securities Market Law establishes the Comissão de Valores Mobiliários (CVM), or Securities Commission, which together with the Central Bank implements the policies of the Conselho Monetário Nacional (CMN) or National Monetary Council. The CVM is the primary institution responsible for the regulation of accounting and reporting of publicly traded companies.

14. The Corporate Law requires filing of audited annual financial statements that include a balance sheet, a profit and loss statement, a statement of changes in equity, notes to the financial statements, management's discussion and analysis (MD&A) and the report of the independent auditor. Unaudited quarterly statements are required within 45 days of the end of the first three quarters of the fiscal year.<sup>13</sup> Annual and quarterly statements must include governance-related information, including information on shareholders, directors, management and affiliated companies.

15. Companies that have foreign listings and produce financial statements according to the generally accepted accounting principles of another country are required to disclose their foreign statements in Brazil. The Corporate law also determines that the appointment and removal of auditors is the responsibility of the Administrative Council or board of directors. As is the case with European Union requirements, private companies organized as Sociedade Anônima or joint stock companies must file statements with the Board of Trade and publish their results in newspapers.

16. In 2001, changes to the Corporate Law were approved by the Senate. The changes altered governance practices in Brazil, making them more transparent, more democratic and more favourable to minority shareholders. "Tag along" rights now require that voting shares be bought out at 80 per cent of the price offered for a controlling stake, and only 50 per cent of shares issued can now be "preferred" (non-voting) shares. With respect to disclosure, members of the Conselho Fiscal must now provide their opinions to the AGM and must disclose dissident votes. Most observers feel that the changes are necessary steps in the right direction but insufficient to bring Brazilian governance up to the required level. As is often the problem with highly detailed legislation and regulation, it may be easy for companies to adhere to the letter of the law while not complying with the spirit.<sup>14</sup>

## B. Securities Commission (CVM) Rules and Regulations

17. In June 2002, the CVM published its Recommendations on Corporate Governance. These recommendations are described by the CVM as “good” corporate governance practices that exceed the requirements imposed by law and its own regulations. On the other hand, the CVM also recognizes that its recommendations are not “best practice” and encourages companies to voluntarily seek a higher standard. The CVM pursues a “comply or explain” policy with respect to its recommendations. The recommendations focus to a large extent upon issues of transparency in the ownership and control structure of the enterprise and on other needed disclosures. The disclosure-related elements of the code are summarized below:<sup>15</sup>

- AGMs should be organized in such a fashion as not to hinder shareholder participation; recommendations provide for an appropriately detailed agenda and timely notice.
- The company must disclose all shareholder agreements to which the company is party.
- Shareholder lists must be disclosed. Shareholders holding at least 0.5 per cent of outstanding shares also have the right to full contact information about other shareholders.
- At least two members of the board must have experience in finance and primary expertise in accounting.
- The board should establish specialized committees, in particular an audit committee to review relations with auditors, operating results and related party transactions. Members of the audit committee should have experience in finance and are responsible for supervising the relationship with the auditor. The audit committee must ensure that other services provided by the auditor not constitute a conflict of interest. It must, in addition, establish a maximum level of fees for non-audit services.
- Transactions between related parties should be clearly disclosed in the financial statements as “normal” or arm’s-length transactions.
- Companies must provide an MD&A discussing the factors that influenced financial performance and covering the main risks.
- The recommendations seek to professionalize the function of the *Conselho Fiscal* or fiscal council. The fiscal council is to have access to all information relevant to matters it is considering as long as the provision of information does not violate legal secrecy requirements.
- Companies should provide audited financial statements prepared according to International Financial Reporting Standards (IFRS)<sup>16</sup> or United States Generally Accepted Accounting Principles (GAAP) in addition to Brazilian accounting standards.
- Auditors’ recommendations must be reviewed by the full board and by the fiscal council.

18. Mandatory disclosure is determined by: CVM Instruction 202, which covers initial registration requirements and periodic reporting; Instruction 31, which covers disclosure of material information; and Instructions 69 and 299 (updated by instructions 358 and 361

respectively), which cover disclosures regarding the acquisition of blocks of shares. These Instructions require the filing of audited annual financial statements as defined under the Corporate Law, and unaudited quarterly statements. More stringent penalties for disclosure violations have been introduced recently to encourage better compliance with rules that are not infrequently flouted. Statements must be filed both with the CVM and with the exchange on which the company is listed, where they are generally accessible via websites.

19. With respect to the attestation of statements, the CVM requires the certification of annual financial statements by an independent auditor duly registered with the CVM. In order to register, auditors must: (a) submit to examination in order to ascertain their technical qualifications; (b) demonstrate that they have internal controls that ensure compliance with audit norms; (c) undergo regular peer review; and (d) institute continuing professional education programmes.

20. In May 1999 the CVM introduced new registration requirements, found in CVM Instruction 358, that are based in part upon IOSCO<sup>17</sup> resolutions on International Standards of Audit (ISA). The new rules: (a) prohibit independent auditors from acquiring securities issued by their clients or any associated entities; (b) mandate forced rotation of audit firms; and (c) prohibit accounting firms from auditing entities from which they are not independent.

21. The list includes services that auditors may not provide to clients if they wish to maintain their independence. They include: (a) corporate restructurings; (b) valuation of enterprises; (c) asset valuation; (d) assistance in valuing provisions; (e) tax planning; (f) internal control systems; and (g) any other services that may threaten auditor independence. The prohibition on certain services contained in Instruction 358 anticipated by a number of years similar legislation passed in the United States in the wake of the collapse of Enron. Instruction 381 mandates the disclosure of permitted service fees.

### C. Accounting standards

22. There are two recognized sets of accounting principles used in Brazil: (a) Corporate Law principles; and (b) the so-called *Correção Monetária Integral*, which is an accounting method established by the *Conselho Federal de Contabilidade* or Federal Accounting Council (CFC) that restates the financials to adjust for inflation. The principles established by Corporate Law principles are legislated and are applied by all Brazilian companies for tax and financial reporting. CFC statements are not required but are sometimes provided in addition to statements required by law.

23. In addition, the *Instituto dos Auditores Independentes do Brasil* or the Brazilian Institute of Accountants (IBRACON),<sup>18</sup> a private sector professional body, issues standards that supplement both sets of principles. These standards are endorsed by the CVM and are used by publicly traded companies. Further instructions may be issued by the CVM. Where specific rules regarding a particular accounting treatment cannot be found in domestic sources, Brazilian companies may look to IFRS or US GAAP for guidance.

24. Brazilian accounting standards differ significantly from IFRS. The most significant differences are outlined in a survey conducted by the Big 5 accounting firms entitled “GAAP 2001: A Survey of National Accounting Rules Benchmarked Against International Accounting Standards”. The survey compares domestic standards with IFRS and groups differences into four major categories: (a) rules comparable to IFRS are absent; (b) specific rules requiring disclosure are absent; (c) inconsistencies between rules could lead to differences from IFRS; and (d) other issues could lead to differences from IFRS. Some of the

differences in the first category (the area that could result in the greatest differences in financial statements) relate to rules on recognition and measurement, the consolidation of special purpose entities, employee benefits obligations, intangible assets, impairment of assets and leases among others.<sup>19</sup> Brazil was also one of the 59 countries surveyed in *GAAP Convergence 2002*.<sup>20</sup>

25. It is broadly recognized that convergence with IFRS could enhance the quality of financial reporting considerably. With this objective in mind, the CVM commissioned a group that will recommend how to harmonize Brazilian accounting practices with IFRS. The proposals that are being discussed would require changes in the Corporate Law that would include the introduction of a cash flow statement in place of a statement of changes in financial position, a new format for the income statement, increased disclosure of segment information, extraordinary items, and discontinuing operations among others. Statements would need to be consolidated where applicable and audited.

26. While these reforms are necessary, some observers question whether accounting principles should be embodied in law at all. It is not uncommon for countries to include detailed instructions for both accounting and audit in law. However, legislation tends to be an unwieldy instrument, ill adapted to the constant revision and improvement that accounting and audit standards require. It is often suggested that the law set out only the broadest fundamental requirements and derogate the authority for technical rule making to specialized standard setters.<sup>21</sup> Other observers, citing the danger of watered down standards, suggest that IFRS be applied directly without modification or adaptation by a local standard setter.

## **II. The Private Sector**

### **A. The São Paulo Stock Exchange (BOVESPA)**

27. The São Paulo Stock Exchange or BOVESPA was founded on 23 August 1890. Brazil had until recently nine stock exchanges. Until the mid-1960s, BOVESPA and other Brazilian exchanges were official entities linked to the finance departments of the Government. These exchanges were all merged in 2000 into BOVESPA. BOVESPA is now a self-regulatory organization under the supervision of the CVM. It has captured the attention of the international corporate governance community through its innovative use of market forces to encourage voluntary improvements in disclosure and corporate governance.

28. The main features of its new approach are the creation of three new listing segments: the *Novo Mercado* or New Market and two “Differentiated Corporate Governance Levels” (referred to as Level 1 and Level 2 listing segments). The *Novo Mercado* was established as a completely new market for initial public offerings with stricter listing requirements than companies already traded on the regular exchange. The Differentiated Corporate Governance Levels are intended to apply to companies already listed on the exchange. Listed companies may now receive a higher level rating based upon compliance with higher standards of corporate governance.

29. The additional commitments made by Level 1 BOVESPA companies revolve primarily around enhanced transparency and disclosure. Level 2 companies undertake to go further by using internationally accepted standards for accounting and by adopting rules of governance designed to better balance the power of controlling and minority shareholders. The *Novo*



*Mercado* listing rules correspond in their essence to a Level 2 listing on BOVESPA. In addition, *Novo Mercado* companies commit to only issue voting shares that have one vote.

30. Listing on these special segments has some important implications. The board of directors and officers must sign a contract agreeing to a set of new commitments. All three segments must maintain at least a 25 per cent free float and either guarantee access to shares for all interested investors or allocate 10 per cent of their total offering to individual or non-institutional investors. The “dispersion procedure” must be described in the company prospectus. In the event that a company no longer wishes to be listed under Level 2 or *Novo Mercado* rules, it must seek shareholder approval for the change and make a public tender for the outstanding shares of the company at the fair market value<sup>22</sup> of the company. Level 2 companies must also abide by the decisions of a Market Arbitration Panel, established by BOVESPA to resolve shareholder disputes. Penalties may be imposed if rules are violated.

31. The efforts of BOVESPA since the launch of the new levels have focused on encouraging companies to voluntarily migrate to higher levels. The benefits of migration and greater transparency are supposed to be a lower cost of capital and improved reputation for companies. Benefits for the stock market are improved liquidity and international recognition as a significant exchange.

32. In addition, shortly after creating the new listing levels, BOVESPA introduced a new market index composed of companies listed on the *Novo Mercado* and Level 1 and 2 BOVESPA companies. The IGC or “Corporate Governance Index” was the only one of Brazil’s five major indices to end the year in positive territory in 2002.

33. A summary of the new reporting requirements for the two corporate governance levels follows:<sup>23</sup>

34. Level 1 reporting requirements:

- Quarterly and annual consolidated financial statements, including consolidated and unconsolidated cash flow statements.
- Disclosure of the beneficial owner of any direct or indirect interest in the company in excess of 5 per cent of voting capital.
- Disclosure of the number and type of shares held by controlling shareholders, members of the board, members of the fiscal council and executive officers. This information may be disclosed in aggregated form.
- Report on purchases or sales and changes in the types of securities held by the above group within the preceding 12-month period on a monthly and individual basis.
- Report on the level of free float.
- A special “review report” issued by the independent auditor of quarterly financial statements.
- An opportunity to meet with analysts and other interested parties in order to discuss the company’s financial condition and prospects at least once a year.
- The company must publish an annual agenda that lists all important dates such as meetings, release of quarterly numbers and other relevant events.
- Related party transactions must be disclosed in excess of certain limits, including sufficient data to evaluate whether transactions have taken place under “normal” market conditions.
- Shareholder agreements must be disclosed.

- Information on stock option plans for employees and executives must be disclosed.
- Monthly reports must be made on trading of shares and derivatives by insiders.
- The prospectus must include disclosure of risk factors, description of the company's business and an MD&A among other information.

35. Level 2 requirements:

- Compliance with Level 1 requirements.
- Preparation of annual financial statements according to US GAAP or IFRS. Statements must be filed in English.
- Enhanced rules for corporate governance, including features designed to reduce director entrenchment, voting rights for certain shareholders on key issues and enhanced buyout rights ("tag along" rights) in the event of the sale of the enterprise.

36. The results of an initial study conducted on the behalf of BOVESPA indicate that companies that migrated to higher levels on the exchange experience higher share valuations, trading volumes and liquidity, thus supporting the theoretical basis for improved governance in practice.<sup>24</sup> On a more practical level, BOVESPA has come under intense pressure from companies to be more "flexible." But it has kept the commitments under the Levels and the *Novo Mercado* intact. BOVESPA earned recognition for its firmness when VARIG, the Brazilian national airline, lost its Level 1 listing owing to violations of the listing rules.

37. Originally, the *Instituto Brasileiro de Governança Corporativa* or the Brazilian Institute for Corporate Governance (IBGC) was somewhat less sanguine about the level of corporate governance that had been set. A survey of 15 Level 1 companies found that, although improving, few companies complied fully with the IBGC code. Today, some two years after the establishment of the *Novo Mercado*, companies have adapted, and the timing is considered good for revisiting and raising the requirements to a higher level.<sup>25</sup>

## **B. Investors, associations and other groups interested in corporate governance**

38. One of the key impediments to the exercise of greater oversight by investors has been the prevalence of preferred non-voting shares. With no voting rights, Brazilian investors have had limited ability to exercise influence over corporations. Institutional investors have traditionally been passive and foreign investors have also been reluctant to adopt a more active stance. Attitudes are changing as laws and regulations are modified to provide better opportunities for investors to assert their rights. Other groups that defend better corporate governance have maintained a higher public profile and played a more assertive role.

### **(a) *The National Association of Capital Markets Investors (ANIMEC)***

39. Minority shareholder interests have been advanced considerably by the *Associação Nacional de Investidores do Mercado de Capitais* (ANIMEC) or the National Association of Capital Markets Investors. Founded in 1999, its objective is to defend minority shareholder interests.<sup>26</sup> ANIMEC seeks to influence all of the key institutions that determine the shape of the Brazilian capital market, including the legislature, the executive and judiciary, as well as the CMV and individual stock exchanges. At present, ANIMEC has not produced any particular statements on disclosure; it appears to pursue an approach of legal activism linked to a strong public awareness campaign.

**(b) *The Brazilian Institute for Corporate Governance (IBGC)***

40. Other private sector groups that promote corporate governance are growing in strength and recognition. The best-recognized body is the *Instituto Brasileiro de Governança Corporativa* or the Brazilian Institute for Corporate Governance (IBGC). Originally established in 1995 as the *Instituto Brasileiro de Conselheiros de Administração* or Brazilian Institute of Directors, the new IBGC has broadened its mandate to cover governance. It developed its first code on board practices in 1999, and this was recently revised and enlarged. In April 2001 the new Code of Best Practices of Corporate Governance was completed. The code was the result of broad-based deliberations that included government and the private sector, and it draws some of its inspiration from other well-known international codes. A summary of the key elements that deal with corporate governance disclosure follows:<sup>27</sup>

41. On disclosure:

- The Chief Executive of the company is responsible for the disclosure of relevant information, whether required by law or not, to all stakeholders.
- The annual report should exceed requirements imposed by law. Financial reports should be prepared according to IFRS or US GAAP. Material changes arising between reporting periods should be immediately disclosed to the public. Company statements should be unbiased.
- Companies should disclose their governance policies in the annual report.
- Remuneration should be disclosed on an individual basis for all executives and directors.
- On selective disclosure, material information should be disclosed to all market participants simultaneously.

42. On audit:

- The auditor should provide an opinion on the financial statements. The audit should be conducted in accordance with appropriate professional standards. The auditor should assess internal controls and procedures.
- The audit work plan and auditor fees are to be agreed jointly between the board and the audit committee.
- When the auditor provides consulting services to the company, the board must ensure that the auditor remains independent.
- The auditor's clients are the owners, the board and the audit committee.
- Auditors must cooperate fully with the fiscal council and assist in fulfilling its mandate. Auditors may not sit on fiscal councils.
- The auditor must make annual written confirmation of his/her independence to the board.

**(c) *The National Association of Investment Banks (ANBID)***

43. Intermediaries such as investment banks are actively seeking to promote better disclosure standards. The *Associação Nacional dos Bancos de Investimento* or the National Association of Investment Banks (ANBID) published its Code for Self-regulation for Transactions of Public Placement and Distribution of Securities in Brazil in January 2002.

This self-regulatory code sets standards for issuing securities for investment banks and proposes improved transparency in public offerings. It draws some of its inspiration from disclosure standards required by the US Securities and Exchange Commission and covers both primary and secondary placements. All 60 members of ANBID must comply with the code when conducting their offerings.

44. The ANBID code requires disclosure of:<sup>28</sup>

- Relevant risk factors
- Industry description
- Description of the business
- Management discussion and analysis of the financial statements
- Securities issued in Brazil or abroad
- Pending legal and administrative proceedings
- Related party transactions
- Relationship between the investment bank coordinating the offer and the issuer

45. ANBID members have the right to indicate that they prepare prospectuses under ANBID rules. By ensuring professionalism within their own industry ANBID members are able to differentiate themselves from the competition and fulfil an important public interest responsibility.

### **C. Companies and industry groupings**

46. Best practice in governance disclosure in Brazil can be found among companies that are part of Brazil's Corporate Governance Index, which is composed of companies on the *Novo Mercado* and those with higher-level listings on the BOVESPA. At the time of writing, there were two companies listed on the *Novo Mercado*, three companies listed as Level 2 companies on the BOVESPA and 27 Level 1 companies with two additional companies expected.

47. Among the 30 companies that receive a Level 1 or Level 2 certification from BOVESPA, less than one third have an independent director on the board.<sup>29</sup> While the substance and reporting of governance could improve, companies are reacting to their own needs for capital and the demands of capital providers. A limited number of Brazilian companies are successfully introducing greater independence<sup>30</sup>. *Companhia de Concessionárias Rodoviárias* (CCR), the first company to be listed on the *Novo Mercado*, recently nominated Ana Novaes as a fully independent member of its board of directors. The company's strategy was to find a board member with financial markets expertise who could contribute to the company and defend the business, rather than defend the interests of one or another group of shareholders. Improvements along the lines suggested by international practices are thus practically feasible.

48. The other company listed on the *Novo Mercado* is *Sabesp*<sup>31</sup> (São Paulo State Sanitation Company). *Sabesp* is a mixed economy, open capital company that has the São Paulo State Government as its principal shareholder. Approximately 30 per cent is owned by the Government, with the remaining 70 per cent floating freely. The company operates municipal sanitary services under concession. Like CCR it may feel an obligation to be transparent because it provides a public good. Both CCR and *Sabesp* stand out from their peers in terms of disclosure. Both have websites in Portuguese and English, with financial statements and

other CVM filings clearly displayed. Quarterly results and transcripts of analyst meetings are easily accessible. *Sabesp* has won numerous awards in management, including awards related to the sustainability of its operations.

49. *Aracruz* is another frequently cited example of good disclosure. The quality, speed and transparency of the information that *Aracruz* provides the market have been widely recognized. Two recent examples are the 5<sup>th</sup> Transparency Trophy Prize awarded by ANEFAC (the National Association of Finance, Administration, and Accounting Executives), which ranked *Aracruz* among the five companies in the manufacturing sector with the best financial statements, and the ABRASCA<sup>32</sup> Annual Report Prize, which considered *Aracruz's* annual report one of the three best in Brazil. ABRASCA selected *Aracruz* for outstanding transparency in the areas of analysis of economic-financial factors in its MD&A, information regarding risk, and structures and practices of corporate governance.

50. Significant improvements in corporate governance at *Marcopolo*, an auto parts manufacturer, also bear mention. In response to discussions with investors, the company decided to rewrite its by-laws to better respond to investor concerns and to seek a Level 2 listing on the BOVESPA. Its new policy of paying close attention to minority investors interests allowed *Marcopolo* to successfully raise additional capital in late 2002 at a time when the Brazilian market was suffering considerable weakness. It has also won it significant praise from market participants.<sup>33</sup>

51. Best disclosure practices are also visible among companies with Level II and III American Depository Receipts that disclose according to US standards.<sup>34</sup> In September 2001 there were 10, 25 and 44 level III, II and I Brazilian ADRs respectively. One of these companies is *Petrobras*, Brazil's largest integrated oil, gas and energy company. *Petrobras* revamped its financing and governance strategy in order to improve its financial performance compared with a group of peers.

52. Its new strategy was to align controlling and minority shareholder interests with a focus on profitability with environmental responsibility. Its major steps were a diversification of its shareholder base and enhanced corporate governance, and new by-laws, codes of ethics and rules designed to protect minority shareholders. A special focus was placed on transparency. *Petrobras* now has a website in English, Portuguese and Spanish, which includes SEC filings and other information such as analyst reports and ratings. It conducts webcasts, conference calls and frequent analyst meetings and is working on receiving a level 2 listing on the BOVESPA. *Petrobras* also has a Madrid listing, which it sees (along with its New York listing) as vital in achieving its goal of becoming a world-class energy company.

53. The Enron crisis, the passage of the Sarbanes-Oxley Act of 2002 and the resulting regulatory changes in the United States were followed closely in Brazil and elicited a lively discussion, in particular among companies listed on US exchanges. The introduction of an independent audit committee, now mandatory in the United States, has been a primary question of interest. While some Brazilian companies such as *Pão de Açúcar* have already introduced audit committees, other Brazilian companies such as *Petrobras* and *Aracruz* would like to see their existing *Conselhos Fiscais* recognized in the United States as audit committees.

54. One of the principal issues concerns the extent to which Brazilian companies can make their Fiscal Councils independent. US requirements specify that audit committees be composed entirely of independent directors, a demand that would be difficult to meet for Fiscal Councils since controlling shareholders typically nominate a certain number of seats. In addition, the duty to hire and fire the independent auditor resides with the *Conselho de Administração* and not the *Conselho Fiscal*. The extended responsibilities and powers of US

audit committees would also inevitably conflict with the requirements for Fiscal Councils found in the Corporate Law. In order to adapt the existing *Conselhos* to new requirements, Brazil might need to modify their responsibilities to include supervision of the independent auditor and communications between the auditor and the board.

55. *Pão de Açúcar* sees the functions of the *Conselho Fiscal* and the audit committee as being distinct and has, as a consequence, one of each. Its audit committee is composed of three independent directors and a financial expert as required by the Sarbanes-Oxley Act and US listing requirements. Conflicts with Brazilian company law may, nevertheless, remain since the board is legally required to approve the appointment of the independent auditor and not the audit committee.

56. Brazil's large companies, traditionally resource-intensive and with significant impact on the environment, are also demonstrating increased social and environmental awareness that is reflected in voluntary social disclosures. Many companies now make disclosures on sustainability and environmental impact. Among them are *Sabesp* and *CCR*, noted above. Another example is *Ripasa Celulose e Papel*, a level 1 BOVESPA company. The company discloses basic information on compliance with ISO environmental norms and elements of its corporate citizenship programme. A significant portion of the *Petrobras* website is dedicated to a discussion of social responsibility and the environmental impact of its operations. While these disclosures rarely contain numerical information and, unlike financial statements, are not comparable between companies or over time, the disclosures are important advances.

### III. Implementation issues

57. The most important market-driven factor encouraging greater transparency in corporate governance is the increasing number of Brazilian companies that are seeking access to the US capital markets via American Depositary Receipts (ADRs). Foreign listings have raised the quality of domestic reporting, but the overall result has been the loss of Brazilian trading volume to US and European markets. In the future, recapturing some of the lost trading volume may mean bringing investors that prefer the relative safety of US or European exchanges back to Brazil.

58. Another factor that has enhanced transparency has been the opening of the financial markets to international investors. Foreign portfolio investors make greater demands upon companies for information and the disclosures and disclosure policies of some Brazilian companies are clearly being adapted to meet their needs. The absence of voting rights for the vast majority of traded shares still represents a serious impediment to the growth of the Brazilian market and the increased assertiveness of investors.

59. Enforcement of disclosure regulations is an issue of fundamental importance. The CVM regularly publishes a list of major violations of the organization's disclosure requirements. In December 2002, 91 companies were on the list with violations going back years. Even though disclosure violations can result in fines and de-listing,<sup>35</sup> companies regularly ignore CVM rules. The inability to have legal recourse in cases where shareholder rights are violated also deters investor activism. Conflicts may take years to resolve and decisions are often subject to multiple appeals. The CVM recognizes that it does not have the powers or the resources to enforce compliance with its determinations.

60. The effectiveness of voluntary approaches to improving corporate governance has still not been proved. While a lower cost of capital for companies would appear to be a very

attractive incentive, so far the private benefits of control in Brazil appear to outweigh the benefits of improved CG such as lower cost of capital. This conclusion appears to be corroborated by the significant premiums paid for control of Brazilian enterprises and the considerable resistance to change from the corporate sector.

61. Some of the key problems to tackle in the future are old and familiar issues: further improvements to the Corporate Law that would enhance and protect rights of investors; improvements in the adequacy of accounting disclosure; better enforcement mechanisms to ensure compliance; and additional resources for regulatory agencies. Some existing oversight institutions may need to be revamped and others created such as perhaps an independent oversight body for the audit profession. Changes in these areas would likely generate improved standards and practices of accounting and audit, and ultimately improve transparency. Structural changes would also shake the passivity of institutional investors by giving them the incentives and power to act.

## NOTES

<sup>1</sup> How capital markets growth ranks within the current Government's reform priorities remains to be seen.

<sup>2</sup> Mauro Rodrigues da Cunha, Bradesco-Templeton.

<sup>3</sup> For example, share capital listed on the BOVESPA represented 55 per cent of the Madrid stock exchange in July 1997 and only 6.3 per cent in June 2001. Changes are even more dramatic in relation to other international exchanges. Source: BOVESPA.

<sup>4</sup> Approximation of figures for 2002 provided in BOVESPA's "Overview of the Brazilian Economy and the Capital Market, March 2003". Real/US\$ exchange rates prevailing on 9 May 2003 were applied.

<sup>5</sup> Dispersed ownership tends to be the exception rather than the rule among different securities markets.

<sup>6</sup> Voting shares under Brazilian law were until recently as little as a third (or 33.33 per cent) of total outstanding shares. Absolute control could be maintained with half of the voting shares or less than 17 per cent of the total outstanding shares. This figure was increased to 50 per cent by recent changes to the corporate law, so that now control can be maintained with 25 per cent of total outstanding shares.

<sup>7</sup> Flavio Marcilio Rabelo and Luciano Coutinho, "Corporate Governance in Brazil", April 2001.

<sup>8</sup> The ISAR checklist for best practices on disclosure requirements does not take a position on the desirability of disproportionate control structures. These requirements, however, do support full disclosure of such structures so that investors can better assess the potential risks.

<sup>9</sup> Members of the *Diretoria* are referred to as *directors* in Portuguese (*directeur* in French or *director* in Spanish) but are more properly referred to as executives or officers in English. The translation of the Portuguese word *director* as director in English often leads to confusion with the terms applied to board members.

<sup>10</sup> *Conselhos Fiscais* are sometimes translated as audit committees. This is misleading since they have a different historical origin and fulfil a distinct function.

<sup>11</sup> Similar structures exist in Italy and the Russian Federation.

<sup>12</sup> Heloisa Bedicks, Executive Director, IBGC.

<sup>13</sup> Quarterly statements of listed companies undergo an audit review but no full audit.

<sup>14</sup> Mauro Rodrigues da Cunha, "The Corporate Law: The Beginning of the End," *Jornal Valor*, 24 September 2001.

<sup>15</sup> For the full text of the recommendations in both English and Portuguese, see the CVM website [www.cvm.gov.br](http://www.cvm.gov.br).

<sup>16</sup> International Financial Reporting Standards as established by the International Accounting Standards Board (IASB). For more information on the IASB see [www.iasb.org.uk](http://www.iasb.org.uk).

<sup>17</sup> International Organization of Securities Commissions (IOSCO). The website can be found at <http://www.iosco.org/>.

<sup>18</sup> For more information on IBRACON see <http://www.ibracon.com.br/>.

<sup>19</sup> "GAAP 2001, A Survey of National Accounting Rules Benchmarked Against International Accounting Standards" at: [http://www.ifad.net/content/ie/ie\\_f\\_gaap\\_frameset.htm](http://www.ifad.net/content/ie/ie_f_gaap_frameset.htm).

<sup>20</sup> "GAAP Convergence 2002", at [http://www.ifad.net/content/ie/ie\\_f\\_gaap\\_frameset.htm](http://www.ifad.net/content/ie/ie_f_gaap_frameset.htm).

<sup>21</sup> Delegation is common although it may be difficult to implement in practice. Governments may be cautious about delegating for a number of reasons. Changes in accounting standards can directly affect the tax base. There is often concern about enforcement of private sector standards and possible conflicts of interest within private professional bodies.

<sup>22</sup> The actual requirements state that a tender must be made at "economic value" and establishes methods for its determination. It appears that "economic value" and market value would be equivalent.

<sup>23</sup> For a detailed discussion of BOVESPA listing rules in English see [www.bovespa.com.br/indexi.htm](http://www.bovespa.com.br/indexi.htm).

<sup>24</sup> For a full copy of the report "Effects of migration to Special Corporate Governance Levels of BOVESPA", by Antonio Gledson de Carvalho, January 2003, see <http://www.bovespa.com.br/indexi.htm>.

<sup>25</sup> Heloisa Bedicks, Executive Director IBGC. See below for more on the IBGC code.

<sup>26</sup> The ANIMEC website address is <http://www.animec.com.br/>.

<sup>27</sup> The full code can be found on the IBGC website, <http://www.ibgc.org.br/home.asp>. The sections devoted to disclosure and audit can be found in the appendix to this document.

<sup>28</sup> Section 9 of the code (the principal element that deals with disclosures) is included in the appendix to this document. For a copy of the full code in English or Portuguese see <http://www.anbid.com.br/>.

<sup>29</sup> Source: IBGC.

<sup>30</sup> Some supporters of existing governance structures question the need for independence in the Brazilian context. It is pointed out that the close link between owners and managers in Brazil could in fact be considered a governance ideal since there is no separation of ownership and control. However, this argument does not take into account the frequent abuse of minority shareholders by controlling groups and the impact that endemic



abuse of minority shareholders can have on the credibility of the overall market. Finally, owners and managers are not, in fact, equivalent in Brazil since pyramid structures give control to groups that typically only represent a minority of the capital.

<sup>31</sup> Website: [www.sabesp.com.br](http://www.sabesp.com.br).

<sup>32</sup> *Associação Brasileira das Companhias Abertas* or Brazilian Association of Public Companies

<sup>33</sup> Mauro Rodrigues da Cunha, Bradesco-Templeton.

<sup>34</sup> Brazil has a high proportion of domestic company shares trading elsewhere, with some 37 per cent of its trading volume in the United States. Source: BOVESPA.

<sup>35</sup> De-listings are infrequent, although VARIG, Brazil's national airline, recently lost its Level 1 certification on the BOVESPA.