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THE ROLE OF THE STATE IN THE REGULATION OF THE SECURITIES MARKETS: THE BRAZILIAN EXPERIENCE

NELSON LAKS EIZIRIK *

1. Introduction

In analyzing the role of the State in the regulation of securities markets, we must understand that regulation cannot be conceived of as an abstract model. The goals of public policy concerning the securities market will vary according to different economic situations.

The proper choice of regulatory objectives depends on the historic process of development of the securities market. Typically, this development has been evolutionary in character, but in some cases it has emerged as a result of active planning by governments [1]. According to the evolutionary pattern, securities markets have emerged as a response to financing needs; some of their features have undergone changes as financial institutions have grown during the process of 'financial deepening'. In the older western European countries as well as in the United States the primary securities market emerged in the early stages of the industrial revolution as a response to a need for capital by business and governments. But in some countries, including Brazil, the securities market has been created or developed as a result of deliberate governmental policy. In such cases, the government has viewed the market as a means to accomplish financial and economic development. As a result, the securities laws in Brazil exhibit some peculiar characteristics, inasmuch as they seek to establish measures that stimulate the securities market.

The Brazilian securities legislation, first enacted in 1964 and 1965 [2], reflects a clear choice in terms of economic policy: a neocapitalistic economy as a basis for development, emphasizing the financial system and especially the equity securities market [3]. Since the model followed was the United States economy, efforts were made to imitate that country's securities market. Thus, with respect to the protection of investors, the effort was made to reproduce some of the concepts of United States securities regulation. This has caused an endless complex of problems. It is

^{*} The author is senior researcher of the Brazilian Institute of Capital Markets (IBMEC). He would like to express his thanks to Marise Philbois Toledo for her efficient work in translating this article into English.

well known that reorganization of a financial system merely through the adoption of instruments peculiar to more developed economies does not necessarily result in a higher degree of economic efficiency; legal instruments for investors' protection may entail undesirable effects when transferred to other economic contexts. The use of these legal instruments in Brazilian securities market regulation, as well as the problems of adaptation that have emerged, will be among the subjects dealt with in this article.

The present seems to be a suitable moment for a study of these problems in Brazil, since a new Corporations Act was enacted at the end of 1976 [4], instituting important innovations in relation to publicly-held companies [5]. In addition, a Securities Commission (Comissão de Valores Mobiliários — CVM) has been created, directed not only toward increased protection of investors but also toward stimulation of the stock market. These innovations, as well as some forecasts with respect to trends in securities regulation in Brazil, will also be dealt with in this article.

Until now, the securities laws in Brazil have been concerned more with promotion than regulation. The new Corporations Act modifies this situation, giving the legislation a more regulatory aspect. This Act also governs almost all of the subjects that had previously been dealt with in the Capital Markets Law and revokes many of its sections.

It should be noted that the promotional measures in the prior legislation dealt mainly with publicly-held companies (Companhias Abertas or, literally, 'open companies') [6]. It is precisely in relation to these companies that substantial changes in regulation have been made in the new legislation. Since a system of protection of minority shareholders is beginning to be developed, this article will be concerned less with financial institutions, whose situation is not significantly changed by the new legislation, and more with the regulation of publicly-held companies.

2. The new Corporations Act and the protection of investors

It is necessary to emphasize that the reform of the Corporations Law reveals a clear orientation of government economic policy. The reform of the Corporations Law had already been forecast in National Development Plan No. 2 (1975—1979), in which the main economic objectives of such a law were set forth.

The Plan establishes the following priorities for the securities market: reform of the Corporations Law and the strengthening of the stock market. The first priority serves as a means to achieve the second. The Plan calls for reformation of the Corporations Law to provide real protection for investors so as to restore their confidence in the securities market, which had been severely shaken in the 1971 market crisis. In addition, the Plan calls for direct support of the stock market by strengthening institutional investors through the regulation of insurance companies and pension funds and the creation of special funds to attract resources from abroad.

During the period when the Corporations Bill was debated in Congress (a very short period of time, not in excess of 90 days), arguments were heard, especially in the academic community and among entrepreneurs, about the real objectives of the Act and about the 'driving forces' that might have promoted its emergence. The main criticism was that the Act would institutionalize a model of finance capitalism and would create in Brazil a system of financial-industrial-commercial conglomerates, directed by the commercial banks. According to its main critic, Professor Modesto Carvalhosa:

The new Corporations Act will serve to attract the public's savings for the purpose of capitalizing industrial and commercial conglomerates. In this manner, it will provide banks with the means of controlling the shares thus purchased, through their depository, custody and proxy voting functions. The new Act will also allow financial groups to acquire minority control of corporations without having to expend large amounts of their own resources. In order to accomplish this, financial groups will use their own investment banks for stock underwriting.... This method of corporate reorganization will create oligopolistic control of the economy by a few financial institutions, which will end up with substantial participation in companies engaged in the production of a wide variety of goods and services. Thus a pattern of finance capital control will develop, which is antithetical to pluralistic capitalism and free enterprise capitalism [7].

Though the Act regulates all of the firms legally organized as corporations, its main innovations refer to the regulation of publicly-held companies, those whose securities are traded on a stock exchange or in the over-the-counter market. The economic significance of the large corporation is the philosophical base for these innovations. Indeed, National Development Plan No. 2 enhances this significance, since it provides for stimulation of mergers between firms, including those that integrate the financial system:

First of all, it is noteworthy that the trends in market structures in Brazil — in industry, in commerce and in the financial system — have always been completely different from those that prevailed in this century in the United States, for example, which have given rise to the system of antitrust legislation . . . Consequently, a policy of merger of national firms — and that is exactly what has been stimulated — in order to acquire economic scale, implies: intensifying the efficiency of the sector, strengthening domestic entrepreneurs and heightening the degree of competition of the market [8].

According to the main critics of the Act, participation by banks in the administration of industrial and commercial corporations, or at least access to the control of such corporations, would occur mainly through custody and depository services rendered by 'financial institutions'. Since brokers in Brazil are not legally considered to be financial institutions [9], such services would be rendered basically by commercial banks and investment banks. According to the terms of the Corporations Bill, financial institutions were not forbidden to render custody and depository services to corporations of which they were shareholders. This subject received much consideration during the discussion of the Bill, with the result that Section

293 of the final version of the Act allows stock exchanges as well as banks to render such services but forbids financial institutions from being shareholders of corporations for which they render custody and depository services.

As stated previously, one of the objectives of the new Corporations Act is the protection of minority shareholders. The prior Corporations Act, as well as the acts on securities regulation, did not have specific provisions for protection of minority shareholders, except for provisions requiring disclosure by publicly-held corporations.

The system of protection of investors established in the new Corporations Act is based on an important theoretical consideration: in a publicly-held corporation it is necessary to distinguish between the shareholder as owner and the shareholder as investor. Professor Schmitthoff advances an almost similar viewpoint [10]. Thus, "in the large listed company the shareholder is not an owner but he is an investor. He may be a large institutional investor such as a unit trust, an insurance company or a pension fund, or he may be a small investor who invests his savings in a company which has taken his fancy, and he hopes that his investment will be safe and give him a good return". According to the thesis underlying the new Brazilian Corporations Act, the 'true shareholder' is one that participates in the activities of the corporation, having a direct concern for the business, since he holds control or at least a substantial part of voting shares. On the other hand, the 'investor' buys shares just for the sake of investment and typically does not have the status of an owner since he has no voting shares.

In the new Corporations Act, instead of being strengthened, the voting right is really weakened. Under the old Corporations Act, a corporation was not allowed to issue more than half of its capital in preferred shares, which under Brazilian law typically have no voting rights. In comparison, the new Corporations Act allows companies to issue as much as two-thirds of their capital in preferred, non-voting shares. What could have been the reasons for such a change? In the preamble to the Act it is stated that the extension of the maximum limit for the issue of non-voting shares is designed to: (1) augment the freedom of the domestic private entrepreneur as to the capital structure of his firm and its corresponding organization; (2) facilitate the acquisition of control, by Brazilian entrepreneurs, of companies with outstanding shares; and (3) make it possible for small- and medium-size firms, when they go public, to sell just one class of shares (i.e., non-voting preferred shares, not entailing dilution of the voting power of existing shareholders).

The basic objective of such a change is to enable entrepreneurs to sell shares of their corporations in the market, without fear of losing their control. In Brazil a great number of corporations do not capitalize via the securities market for fear that their controlling shareholders' decisions will be disputed in General Meetings of the company, or even that they will eventually lose their position of absolute control. It should also be taken into account that in Section 112 of the Corporations Act voting rights are not granted to bearer shares (which are quite common in the Brazilian market) because the inherent responsibility of the voting right is

inconsistent with the existence of shares whose ownership is entirely floating.

Since bearer shares may be converted into registered shares, holders' voting rights are only partially negatived; in order to have voting rights they must identify themselves by the conversion of the shares. Adding up the two factors mentioned above (two-thirds of shares with non-voting rights, plus bearer shares whose holders do not want to be identified and consequently are not eligible to vote) we will have, as a result, corporations which will be controlled by a small number of shares. This is hardly a democratization of their ownership structure.

It is often argued that the most 'perfect' form of corporation is the one which has management control, that is, ownership is so widely distributed that no family or group has control of the corporation's business. Berle and Means [11] advanced the thesis that developed capitalistic economies would tend to promote a separation between ownership and control in large corporations, with control being increasingly exercised by managers. Should the Brazilian entrepreneurs be induced to give up their power of control? In fact, efforts have been made for some time to promote an 'opening' of corporations, with fiscal incentives as a basis, but, as stated previously, without significant material results.

The Berle and Means' viewpoint features certain ideological objectives, which makes its transportation to other countries debatable. First, the premise that management control exists in many large corporations in the United States has already been the subject of important theoretical discussion [12]. Second, even if we assume the proposition of the distinction between ownership and control, the idea that control exercised by managers implies more efficiency in the microeconomic sense deserves some criticism. Such an idea is openly challenged by studies that demonstrate that corporations controlled by owners show more efficiency in terms of net income [13]. As to Brazil, it is often argued that its domestic private enterprises are somewhat inefficient insofar as they are controlled by families. We think this argument deceptive. The problem lies basically in the lack of qualified managers; mere access to the control of companies will not necessarily change managers into good managers, since what really matters is better technical capacity. The most important step would be investment in the education of professional administrators, even if they eventually begin working in family businesses.

The solution adopted by the new Corporations Act accords with the realities in Brazil. Perhaps this is the only way to promote the development of an equity securities market in a country whose entrepreneurs traditionally do not look favorably at the idea of giving up their control power. Obviously, however, this is not one of the best ways to provide protection for minority shareholders. The ideal solution would be for corporations to issue nothing but voting shares: equity would be more fully served since there would be mutuality between the investor and the entrepreneur concerning the future of the company. The entrepreneur, insofar as he held control subject to challenge, would tend to set as one of his goals the preservation of loyalty on the part of minority shareholders. Moreover, the issuing of voting shares and their distribution among the public would satisfy one of the social roles

that has always been attributed to a securities market: dispersion of the ownership of enterprises previously controlled by families. Thus, we are faced with a situation in which we can clearly perceive that the real is far from the ideal, and the distance between them no easy gap to bridge.

In order to offset this weakening of the voting right, the Corporations Act presents an important innovation: the explicit acknowledgement of 'control power' and the attribution of a series of duties to the controlling shareholder. According to the preamble of the Act, the basic principle that was adopted is that the exercise of control power will be illegitimate unless it complies with its main objective: to enable the company to accomplish its social role. What is more, this power will be legitimate only to the extent that it respects and satisfies the rights and interests of every person connected with the enterprise — workers, minority shareholders, investors and the community itself. Thus, this theory is connected with a broader concept that has been increasingly recognized in all countries that have a market economy: enterprises, especially the large corporations, should aim not only at earnings, but also at social goals.

How to implement this concept? One of the ways (adopted by the Brazilian legislation) would be to make the majority shareholder liable for the exercise of his control power. So, in accordance with Section 117, the controlling shareholder is responsible for damages caused by acts derived from abuse of power. The Act lists and illustrates some of the types of abuse of power: misleading the corporation to objectives inconsistent with its social role or damaging to the national interest, or leading it to favor another corporation, to the prejudice of minority shareholders or of the domestic economy itself; promoting the liquidation or merger of the corporation in order to obtain personal advantage; promoting changes in the bylaws, issuing securities or making decisions that are damaging to minority shareholders, workers and investors; electing unqualified managers; inducing or attempting to induce directors to perform illegal acts; and approving irregular accounts presented by managers. In any of these, or similar, cases, the injured person has the right to bring a suit against the controlling shareholder.

The controlling shareholder is defined in a pragmatic manner and no fixed minimum percentage of equity is prescribed. Thus, in accordance with Section 116, a controlling shareholder is the person (or group of persons) who: (a) holds shareholder rights which assure him, on a permanent basis, of the majority of votes in the deliberations of the General Meetings as well as the power to elect a majority of the directors of the corporation; and (b) actually makes use of his power to direct the activities of the corporation and to orient the operation of the administrative bodies of the corporation. Two criticisms have been directed against this conception [14]: (1) it does not include the possibility of managerial control; and (2) it also does not include the possibility of external control, exercised by another corporation that, although not a shareholder, exercises a 'dominant influence' [15]. But control exercised by shareholders is the only hypothesis considered by law. As to managerial control, there will probably be no major problems, since a series of

duties is established by law, quite similar to those of the controlling shareholder, which we will analyze further on. However, in relation to external control, the criticism is valid. Indeed, this is an area that needs to be developed in our Corporations Law.

In addition, there are some important rules concerning the responsibility of directors and managers. When they first take office in publicly-held companies, they must disclose their holdings of shares, stock options, and calls on shares or convertible debentures issued by the company, by a controlled company or even by a company of the same group. In addition, they are obliged to disclose to the General Meeting any relevant information about the activities of the enterprise which has been requested by shareholders holding at least 5% of the shares of the corporation. They must also communicate immediately to the stock exchange as well as disclose through the press any decision of the General Meeting or of the administrative bodies, or any relevant fact in the business of the company, which may substantially influence the decision of investors to buy or sell securities of the company. It should be noted that the Securities Commission (CVM) is granted an enormous responsibility in this particular matter. This is so because it will be up to this agency to decide whether relevant facts about the company should or should not be disclosed when directors refuse to give information they believe poses a risk to the legitimate interests of the company.

Another important innovation in the new Corporations Act concerns the rules restricting insider trading. Though this subject had occasionally been mentioned in the previous legislation, a clear definition of insider trading was lacking. Section 155 of the new Corporations Act provides that insiders are to safeguard any information not yet divulged to the market, obtained because of their function, which may exert significant influence on the quotation of securities issued by the corporation. In addition, they are forbidden to make use of such information in order to obtain, through buying or selling securities, advantages for themselves or for third parties. Any person injured by the performance of the insider can bring a suit to recover damages.

This section of the Act involves two problems: (1) only directors, managers and members of the Fiscal Council are included in the insider trading restriction, the controlling shareholders not being considered insiders; (2) 'tippees' or 'sub-tippees' are not forbidden to trade. Obviously, the enforcement of the restriction on insider trading will depend, to a great extent, on lawsuits being brought by injured investors as well as on the performance of the stock exchanges and especially of the Securities Commission. The stock exchanges are responsible for continuous surveillance of the market and must reveal any suspicion of insider trading to the Securities Commission so as to enable the proper legal measures to be taken. There is ample provision for administrative penalties.

The success not only of the restriction on insider trading but also of the rules on liability of directors, managers and controlling shareholders will depend to a great extent on the development of legal thought with respect to corporations and finan-

cial institutions. In this sense, we may be faced with a 'bottleneck' in securities regulation. Though Brazilian law has imported a series of the principles and even legal standards of United States securities regulation, the profound difference in the situations of the two countries as well as in their traditions of judicial power give rise to serious problems, basically in relation to the application of the law by judges [16].

The number of lawsuits on corporate and securities regulation in Brazil is quite small [17]. There is practically no jurisprudence on the liability of directors and managers and on the rights of injured investors. For instance, although the prior law on corporations guaranteed the possibility of derivative suits by shareholders against directors, no such lawsuits have been brought. Why has the number of lawsuits been so small? It is often argued that the Brazilian investor is unwilling to fight for his rights, preferring, when he is injured, to sell his shares and look for another investment instead. This attitude reflects a cost-benefit analysis. The costs involved in bringing a lawsuit are high. First, these lawsuits are time-consuming. They may take from 10 to 15 years in case of appeal to the Supreme Court. If the plaintiff loses, he must pay the costs of the lawsuit as well as the fees of the attorney of the opposing party. In addition, there are no attorneys specializing in this kind of suit, acting as entrepreneurs in the business of enforcing law against either directors or corporations.

According to Mundheim [18], one of the most important reasons for the development of the private enforcement of securities laws in the United States is the class action. The class action device makes substantial attorney's fees possible, since they are calculated as a part of the total fund recovered for all the plaintiffs. Although not precisely provided by law, it would be possible to develop suits in the Brazilian legal system similar to the class action. But how would it be possible to initiate a system of class actions if attorneys were still unwilling to do so? In Brazil, we believe that the stock exchanges could be pioneers in this field. Legal departments of the main stock exchanges have furnished legal advice to investors, although until now in only a sporadic way. In economic theory protection of investors by stock exchanges constitutes a classic instance of the capture of social benefits when they differ from private benefits. Successful prosecution of insider trading cases would produce social benefits for investors as a class. But as we have said previously, in order to bring a suit the investor will take costs and benefits into account and will look only for private benefits. Investors individually are unwilling to pay for benefits, such as credibility and safety of the stock market, which would be shared by others besides themselves. However, as institutions, stock exchanges can benefit by taking action to protect investors, with consequent increased investor confidence in the market, and can also 'capture' social benefits on behalf of investors. In markets that still suffer from a lack of confidence on the part of investors, it is vital for the stock exchanges to regain that confidence by exerting more efforts toward the defense of investors' rights.

3. The Securities Commission (Comissão de Valores Mobiliários - CVM)

One of the most important aspects of the reform of Brazilian securities regulation is the creation of the CVM [19]. Until now, there has been no specialized agency dealing specifically with the regulation of the stock market. Although inspired to a certain extent by the Securities and Exchange Commission of the United States, the CVM has some characteristics that are quite peculiar. Differently from the SEC, the CVM is not exactly an independent agency, since it is linked to the Minister of Finance and subordinated to the National Monetary Council. It is not a bipartisan commission, and has no links with the Congress. Although it has a legal personality of its own, it is clearly linked to the executive through the Minister of Finance. The Commission has five members, appointed by the President of Brazil, one of them being the chairman, The chairman of the CVM has a seat, with the right to vote, in the National Monetary Council. This is a matter of signal importance, since it enables the CVM to take part in decisions of the Monetary Council, which are generally directed to long-term economic policies in matters of credit and of the financial system. Both the chairman and the commissioners can be dismissed ad nutum; in practice, this means that membership in the Commission will probably be changed pari passu with the Government.

According to the law, the CVM is supposed to: (1) stimulate the formation of savings and their investment in stocks and debentures; (2) promote the expansion and the efficient and regular operation of the stock market as well as permanent investment in stocks issued by domestic publicly-held companies; (3) assure the efficient and regular functioning of the stock exchanges and of the over-the-counter market; (4) in general, protect stockholders and investors; (5) restrain frauds and manipulations in the market; (6) assure investors access to information about publicly-held companies; (7) assure the observance of equitable practices in the market; (8) assure the observance, in the market, of credit terms fixed by the Monetary Council.

Consequently, its legal authority is basically related to stocks and debentures, stock options, founders' shares, and certificates of deposit of stocks or debentures. In order to be sold in the market, these papers must be registered with the CVM, the issuing companies being obligated to comply with the process of disclosure. Public debt securities (National Treasury Bills and Indexed National Treasury Bonds) are categorically beyond the supervision of the CVM's legal authority. Transactions with such securities, which constitute the so-called open market, will still be supervised by the Central Bank of Brazil.

In a quite rational way, it was established that the CVM will assume its role as a regulatory agency gradually. Soon after its creation in December, 1976, the process of appointing the chairman began, the commissioners and their advisers being appointed later [20]. As of July 20, 1977, the CVM fully assumed its function of regulation and as advisor to the Monetary Council.

In meetings with people connected with the market, the chairman and the com-

missioners have outlined the objectives of the CVM. First, it has been stressed that one of the principal activities of the CVM, besides regulation and supervision, is stimulation of the market. Starting from the assumption that our market is poorly developed, it has been pointed out that the role of the CVM is one of 'constructing' the stock market. This seems to be consonant with the role of regulatory agencies in countries whose markets are not yet developed. Thus, the CVM, at least at this stage, is especially willing to listen to market representatives, to study suggestions, and later to propose to the Monetary Council measures for strengthening the stock market [21]. It is important to stress that the CVM, though it does not intend to be a planning agency, is closely connected with the elaboration and implementation of measures of economic policy concerning the securities market.

Another aspect pointed out by the chairman and the commissioners is the importance to be attributed to self-regulatory entities. The stock exchanges are the only self-regulatory agencies in Brazil with powers delegated by law to regulate their members; there does not exist any entity similar to the United States NASD to regulate the over-the-counter market. Although the stock exchanges have had this legal power since 1966, major importance has never been attributed to self-regulation. At present, the position of the CVM is that it is up to the market itself, through its own associations, to promote and enforce proper ethical standards, with the Government acting only if self-regulation fails. Incidentally, the law clearly established that the stock exchanges, though they have administrative and financial autonomy, shall operate under the supervision of the CVM. Also, it is up to the stock exchanges, as 'auxiliary' entities of the CVM, to regulate their members. In addition to regulation by the stock exchanges, consideration has been given to stimulating the association of publicly-held companies to establish a Code of Ethics and to promote, privately, its enforcement.

This is still a difficult point to be evaluated. Although the trend in more developed countries is toward increasing government control over the market and diminishing emphasis on self-regulation, we cannot consider the Brazilian attempt as doomed to failure. It is undeniable that a certain degree of self-regulation is always necessary, mainly in countries that have fewer resources at their disposal. Following the same reasoning, if we consider the market as a service, those who should incur the costs of its administration are the financial intermediaries and the investors, that is to say, those who are the consumers of this service.

It should also be noted that the imposition of penalties by stock exchanges is not very common in Brazil. It is interesting to observe that penalties imposed on brokers by stock exchanges often cause the stock price index to fall. There is a psychological explanation for this: investors, still resentful over the 1971 crash, detect in these penalties evidence that the rules still continue to be poorly complied with and that the stock market continues to move on a speculative basis.

The internal regulations of the CVM provide some interesting innovations concerning its administrative performance that are unprecedented in Brazilian law. One objective is to allow those who take part in the market to participate in the elabo-

ration of its regulation. Thus, it is established that the rule-making process of the CVM shall be carried out as publicly as possible. Before promulgating a new rule, the Commission is to hold public hearings in which all involved persons will be entitled to participate, being permitted to offer suggestions as well as to criticize the new measures. Another important innovation reveals the Commission's concern about excessive red tape. The 'Ombudsman' was created in order to curb this excess; he is directly subordinate to the Commission and is empowered to: (1) examine public complaints about the administrative functioning of the CVM; (2) investigate the causes that hamper efficient operation on the part of the CVM; (3) propose to the Commission the adoption of measures to improve the functioning of the internal bodies of the CVM; and (4) supervise the promptness of response by the internal bodies of the CVM to requests that are put to them.

An extremely important point, not yet worked out with clarity, concerns the process of disclosure. Should this principle, developed in countries with more of a tradition of capital markets, be fully adopted in countries which are just at the point of creating or consolidating such a market?

Brazilian legislation with respect to the regulation of corporations was much influenced by the disclosure requirements of the Securities Act (1933) and by the Securities Exchange Act (1934) of the United States. In Brazil there is, as in the United States, a firm principle that the control to be exercised by the government agency should concentrate on the process of disclosure. Registration of an issue would only guarantee to investors that the required information has been disclosed and is at the disposal of those who might be interested in it. Thus, in principle, no governmental control has been established either over the timing of an issue or over the merits of shares offered for public sale. Judgments about the merits of the issue would be made by the investors themselves. In addition, Rule 214 requires an explicit statement in the prospectus that the registration of issues in the government agency means only that documents and information necessary for the investor's evaluation of the risk of an investment are held by this agency as well as by the underwriter and the selling firms.

The soundness of the adoption of the principle of disclosure in Brazil is quite debatable. By the time the 1933 and 1934 Acts were enacted in the United States, a well developed stock market already existed, though it was not well organized. There was, by that time, a tradition of stock markets and a large number of sophisticated investors. In Brazil, the situation was quite different, since the stock market was not well developed and the number of investors was small. One of the objectives of the economic policy in force by that time was to enlarge the number of investors, thus popularizing the market. In other words, the priority consisted of an attempt to attract new investors, people who had never before resorted to the stock market to invest their savings.

To a certain extent, the process of disclosure is based on the assumption that the rational investor, once he has information, will be able to compare the different possibilities of investment and choose the one which seems to be the most prom-

ising to him. Nevertheless, this assumption will prove to be correct only if investors really have access to information and are capable of using it in an appropriate way. In Brazil, since a market tradition does not exist, this assumption is incorrect. Information is useful, consequently, almost exclusively to financial institutions capable of analyzing it from a technical point of view and to certain institutional investors. The number of individual investors who are really trying to look for and make use of information is quite small, almost insignificant. The same kind of criticism could be formulated with respect to the adoption in Brazil of the United States system of the prospectus as a document of disclosure.

Adoption of the process of disclosure in Brazil has occurred basically in formal terms, since even the calibre and trustworthiness of the disclosed information are questionable. To a great extent this is so because there is a lack of pressure on the part of the investor (via the regulating agency or even via the courts) for a system of disclosure of more accurate information. Thus the assumption that Brazilian investors will be properly protected if there is a system of disclosure seems fallacious.

It is worth mentioning that many abuses were committed in the period 1966—72 principally because of the investing public's ignorance of the precise meaning of the process of disclosure. Many investors bought new shares because they were led to believe that the registration of the issue in the Central Bank meant a government guarantee of the investment. Incidentally, this is the reason why it was required that the prospectus make specific mention of the fact that the registration of the issue in the Central Bank meant only that the legally required information had been furnished. Nevertheless, even if this warning was understood by more sophisticated investors, it was missed by those who happened to be more distant from the market. This matter was and still is aggravated by the existing Brazilian tradition of strong State participation in the economy which justifies the expectation that it should 'guarantee' new issues of stocks.

Another problem is the strong opposition by the domestic private entrepreneur to the disclosure of information about his firm for fear of competition from firms that operate in the same sector. This problem is aggravated by the fact that branches of multinational corporations do not go public in Brazil, which exempts them from furnishing information that is required for Brazilian publicly-held companies. Obviously, this can provoke some disparity in competition, since the disclosure of confidential data may, under certain circumstances, be harmful to the publicly-held company.

Such problems should be studied by the CVM so that a clearer determination can be made of the appropriate policy of disclosure for the securities markets in Brazil. The author believes that substantive regulation of issues in the primary market should be given more emphasis. In other words, the CVM should examine the merits of issues by firms going public for the first time. Thus more emphasis should be placed upon analysis by the CVM of the economic viability of issues and of the ability of the market to absorb them. As to stocks negotiated in the secondary market, a higher degree of attention should be directed to current disclosure, so that the prices of securities really reflect the essential facts about corporations.

4. Conclusion

The State has participated in the securities market in Brazil mainly as a promotional agent (through 'promotional measures' such as fiscal incentives) and as an agent to attract and lend resources. In effect, the State captures about one-third of the resources mobilized through the financial system and accounts for more than half the total of loans to the private sector, most of them being for investment capital. Consequently, its main role as a financial agent is that of supplying resources in a credit area in which private financial institutions lack the necessary ability to act.

However, the need for more regulation of the securities market is now beginning to be emphasized. Although the role of the CVM as an agency created to organize and develop this market has been stressed, it is basically a regulatory agency. Its creation reflects the acknowledgement that, in the long run, there can be no market development without appropriate regulation. This notion supplements the idea previously adopted in Brazil that it was first necessary, at any cost, to develop the market before instituting tighter control over publicly-held companies and financial institutions.

The reform of the Corporations Act and the creation of the CVM have provoked important legal discussions about Brazilian securities regulation. Though these reforms tend to improve the level of protection of investors, there is a long way to go. As is well known, efficient performance by an administrative agency is not enough. Genuine surveillance by self-regulatory agencies is needed, as well as the development of a jurisprudence of corporations and securities law. It should be noted, however, that even in relation to these aspects the CVM's participation, though indirect, is fundamental: as to the stock exchanges, acting as a kind of 'watchdog'; as to the courts, intervening in lawsuits as amicus curiae [22].

Just as it performed an absolutely decisive role in the creation of the securities market, the State must be the main actor in the regulatory process in Brazil, if the protection of minority shareholders is to be a real goal. As a matter of fact, this participation seems to be more and more inevitable in countries whose economic development is intended to be promoted, whatever the chosen ways.

Notes

- [1] The principal differences between the 'evolutionary path' and the 'planned approach' are analyzed in Gill, The Money and Capital Markets for a Developing Asian Economy a Case for Planning, First Asian Securities Forum On The Securities Industry As A Force For Asian Economic Progress (1975).
- [2] L. No. 4595, Dec. 31, 1964, disciplined the financial market; L. No. 4728, June 14, 1965, regulated the securities market. The latter is known as the Capital Markets Law, the expression Capital Markets being used to denote the markets for long-term debt and equity securities. For a comprehensive analysis of the Brazilian Capital Markets Law, see Poser, Securities Regulation in Developing Countries: the Brazilian Experience, 52 Va. L. Rev. 1283 (1966). (Brazilian legislative enactments cited in this article are published in Coleção das Leis, Atos do Poder Legislativo.)
- [3] For an economic analysis of the purposes and results of the financial markets reforms initiated in 1964, see Ness, Financial Markets Innovation as a Development Strategy: Initial Results from the Brazilian Experience, 22 Economic Development and Cultural Change 453 (1974).
 - [4] L. No. 6404, Dec. 15, 1976.
- [5] Publicly-held companies were defined in terms of the dispersion of their shares among the public. Thus a corporation would be considered a 'publicly-held company' if at least 20% of its shares were held by the public, the criteria of dispersion of shares varying in accordance with the capital of the company and with the geographical region in which it was located. In the new Corporations Act a corporation is defined as 'publicly-held' when its equity securities or debentures are traded on a stock exchange or in the over-the-counter market.
- [6] The 'promotional measures' concerning publicly-held companies have a fiscal nature. Tax incentives have been established for the equity securities market, some of them benefiting publicly-held companies directly or indirectly. The most important was introduced through D.L. No. 157 (1967) (published in Coleção das Leis, Atos do Poder Executivo), which created the "Fiscal Funds 157". The scheme enables taxpayers to invest in Fiscal Funds a percentage of their income tax liability (10% to 24%, depending on income). These Funds, administered by financial institutions, are basically directed to the equity securities market, with the specific objective of strengthening it.

The other tax incentives are as follows:

- 1. Fiscal incentives concerning natural persons trading in shares:
 - 1.1. Dividends paid to natural persons are subject to an income tax of 15% when paid by publicly-held companies, as compared to an income tax of 25%, in the case of distributions by closed companies;
 - 1.2. It is possible to deduct from taxable income 25% of the amounts invested in the subscription of shares of publicly-held companies; the shares may not be traded for a period of two years;
 - 1.3. Dividends distributed by publicly-held companies which are actually invested in the subscription of new shares of these companies during the same fiscal year are taxexempt;
 - 1.4. Of the amount invested in the purchase, on stock exchanges, of shares of publicly-held companies, 10% is tax-deductible, provided that the portfolio remains under custody (with free securities trading) in a financial institution;
 - 1.5. Of the amounts invested in the purchase of shares of funds, a natural person can deduct 13.5% of his income tax, provided that he holds the shares for more than two years.
- 2. Fiscal incentives concerning publicly-held companies:
 - 2.1. These companies are exempt from the 5% taxation on the value of dividends paid.

- [7] Carvalhosa, A Nova Lei das Sociedades Anônimas e seu Modelo Econômico 58 (1976).
- [8] Brazil. Presidência da República, II Plano Nacional de Desenvolvimento -- 1975/1979 (1974).
- [9] The legislation is still quite confusing with respect to the definition of a 'financial institution'. As the Central Bank interprets it, broker-firms are considered to be 'auxiliary institutions' of the market.
 - [10] Schmitthoff, Commercial Law in a Changing Economic Climate (1977).
 - [11] Berle and Means, The Modern Corporation and Private Property (4th ed. 1968).
- [12] In a work of great importance, Zeitlin challenges the methods of investigation adopted by Berle and Means, as well as their conclusions on the separation between ownership and control in large corporations. Zeitlin, Corporate Ownership and Control: The Large Corporation and The Capitalist Class, 79 Am. J. Soc. 1073 (1974).
- [13] Monsen, Chin and Cooley, The Effect of Separation of Ownership and Control on the Performance of the Large Firm, 82 Q. J. Econ. 435 (1968).
 - [14] Comparato, O Poder de Controle na Sociedade Anônima (1976).
- [15] This concept of 'dominant influence' is referred to in the German Stock Corporation Act, Aktiengesetz § 17 (1965).
- [16] The 'Capital Markets Law', supra n. 2, as well as later legislation on securities, adopted a number of legal standards from United States securities regulation; such standards, instead of being interpreted by the courts, have been interpreted by the Central Bank, an administrative agency. As is well known, legal systems based on the Civil Law (and this is the Brazilian case), as opposed to those based on the Common Law, do not use legal standards in general; instead, they use legal definitions, which are typically quite detailed. In addition, in Brazil, securities regulation has always been considered to be a matter of economic policy, to be conducted basically by the executive power through government decrees, rules and regulations.
- [17] We are about to complete a research project on jurisprudence about corporate and securities law in Brazil. We have verified that, over the last decade, in the eight main courts of the country there have been no more than 400 final decisions. Of this total, no more than 5% were related to suits on liability of managers, directors or corporations. Besides that, the number of suits involving publicly-held companies is insignificant: only two. The great majority of cases have involved problems among shareholders in 'family companies'; suits brought by injured investors are practically non-existent.
- [18] Mundheim, Regulação do Mercado de Títulos nos Estados Unidos, Revista Brasileira de Mercado de Capitais, Rio de Janeiro, IBMEC, v. 2, n. 5, May/Aug. 1976.
- [19] The CVM was created by L. No. 6385, Dec. 7, 1976. This Act deals with the regulation of the securities market, revoking many sections of the Capital Markets Law. Previously, the tasks of surveillance of the stock market were committed to the Central Bank, which is also responsible for issuing currency as well as for the execution of policies concerning credit, the financial system and the control of foreign capital. The elaboration of such policies is attributed to the Monetary Council, a deliberative body presided over by the Minister of Finance.
- [20] The chairman and the commissioners have been appointed and are exercising their functions. The chairman, Roberto Teixeira da Costa, is an executive with 18 years of experience in the securities market, in addition to having been vice-president of a large financial group. Commissioner Jorge Hilario Gouveia Vieira is a lawyer, expert in corporate and fiscal law and professor of commercial law. Commissioner Geraldo Hess was an executive for one of the largest publicly-held companies. Commissioner Antonio Milão Rodrigues, who held the position of sub-secretary in the Federal Revenue, is an expert in fiscal issues. Commissioner Emanuel Sotelino Schifferle, who replaced Ney Oscar Ribeiro de Carvalho after his resignation, was an executive for an important investment bank before joining the CVM. Thus, the commissioners have acted mainly in the private sector, being directly or indirectly connected with the securities market. By December, 1978, the technical staff of the CVM numbered about 300

employees, and is expected to reach a total of about 450 employees early in 1979.

[21] According to the chairman of the CVM, "... it seems to me that, with the reform of the Corporations Act and the creation of the CVM we shall have an excellent opportunity to assemble a group of many-sided professionals and, during a period of two years, not only to establish the Commission, but also to make a thorough evaluation of the stock market issues.... Our task has as its prime objective the protection of the shareholder, so that he will return to the market, more assured that, today, 'the rules of the game' protect him, since there is an institution protecting his interest; the second objective of the Commission is to extend the scope of this market so that corporations can make the most of it, thus increasing the number of companies that participate in the stock market. This participation seems vital to us, in order that a dispersion of property takes place, creating a more open society, which, to my mind, is a fundamental ingredient for the vitalization of a market economy". Interview given to Revista da Bolsa (São Paulo, Oct. 1977).

[22] A draft of a Bill is now being prepared to allow the participation of the CVM as amicus curiae, similarly to the United States SEC, in suits involving securities legislation.

Nelson Laks Eizirik (b. 1950) received his Masters Degree in Law in 1976 from the Pontifícia Universidade Católica of Rio de Janeiro (PUC). From 1974 to 1976 he was a Research Assistant of the Brazilian Institute of Capital Markets (IBMEC). He has been a Senior Researcher of the Institute and a Professor of Law at Candido Mendes Law School (Economic Law and Securities Regulation) since 1976. His publications include: Regulação e Controle do Mercado de Capitais — O Papel da SEC na Experiência Norte-Americana (with Hélio O. Portocarrero de Castro) (Rio de Janeiro, 1974); A Evolução Recente da Regulação do Mercado de Capitais nos Estados Unidos, Revista Brasileira de Mercado de Capitais, Rio de Janeiro, IBMEC, v. 2, n. 4, Jan./Apr. 1976, pp. 25-50; O Papel do Estado na Regulação do Mercado de Capitais (Rio de Janeiro, 1977); O Privilegiamento de Informações e o Caso Petrobrás (with Horacio de Mendonça Netto), Revista Brasileira de Mercado de Capitais, Rio de Janeiro, IBMEC, v. 4, n. 10, Jan./Apr. 1978, pp. 7-19; O Liberalismo Econômico e a Criação das Disciplinas de Direito Comercial e Economia Política, in Os Cursos Jurídicos e as Elites Políticas Brasileiras (Bastos, ed., Brasília, 1978).