

DISCLOSURE AND INSIDER TRADING REGULATION: RECENT DEVELOPMENTS IN BRAZILIAN LAW

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1. Introduction

The aim of the present article is to describe and analyze the development of Brazilian law related to disclosure and insider trading regulation. Emphasis will be given to a recent case dealing with insider trading, since this case demonstrates the main difficulties courts have in the application of the law.

General provisions regarding disclosure and insider trading restrictions were established in the Corporations Act of 1976 [1]. Such provisions regulate the responsibility of directors and managers of publicly-held companies (“Open Companies” – *Cias Abertas*). According to section 4 of the Corporations Act, a corporation is defined as “publicly held” when its equity securities are accepted for trading on a stock exchange or in the over-the-counter market.

The enforcement of legislation on disclosure and insider trading is carried out by the Securities Commission (*Comissão de Valores Mobiliários – CVM*). The CVM was created by Law No. 6.385, December 7, 1976. According to the Law, the CVM is supposed to (1) stimulate the formation of capital and its investment in stocks and debentures; (2) promote expansion and the efficient and regular operation of the stock market and encourage permanent investment in stocks issued by domestic publicly-held companies; (3) assure the efficient and regular functioning of the stock exchanges and the over-the-counter market; (4) in general, protect stockholders and investors; (5) prevent frauds and manipulations in the market; (6) assure investors’ access to information on publicly-held companies; (7) assure observance of equitable practices in the market; and (8) assure the observance, in the markets, of credit terms fixed by the National Monetary Council. The legal authority of the CVM is basically related to stocks and debentures, stock options, founder’s shares, and certificates of deposits 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 [2].

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2. Disclosure system

The disclosure system is established, in general terms, in the Corporations Act and, more specifically, in the rules and regulations of the Securities Commission. There are two basic principles of the Brazilian disclosure system, as recently adopted by the CVM.

The first one concerns the position of the Securities Commission as a governmental regulatory agency *vis à vis* public issues of securities, and it was patterned after prior Brazilian legislation, which, in turn, was strongly influenced by the American Securities Act of 1933.

According to this principle, registration of an issue only guarantees to investors that the required information is disclosed and available to those interested in it. Thus, there is no governmental control over either the timing of an issue or the merits of shares being publicly offered for sale.

Pursuant to section 21 of CVM Rule no. 9, of October 11, 1979, registration of a company does not entail a judgement on its merits. The same principle applies for registration with the CVM of a public issuance of securities.

Rule no. 13, of September 30, 1980, which deals with primary distribution of securities, requires that all advertising and selling material in connection thereto contain the following statement: "registration with the Securities Commission means that the documents and information necessary for investors to evaluate the risk of the investment are held by the Commission, the leading underwriter as well as the selling firms."

The second principle consists of the disclosure system being based upon registration of companies rather than on registration of public issues. In this regard, the basic legal requirements are set by CVM Rule no. 9. Thus, if a company wants to go public it must register with the CVM, thereby complying with the disclosure requirements. The rule also applies to companies that have in the past sold their securities to the public. The registration requirement is tied in to the legal definition of publicly-held companies: those which have their securities accepted for trading on a stock exchange or in the over-the-counter market. The basic legal standard in this definition is the existence of investors in equity securities or debentures issued by the company. If such securities are publicly traded, the company is legally considered to be a publicly-held one, regardless of the number or the degree of dispersion of securities being traded. Once registered, the company must comply with the requirements of continued disclosure established by the above mentioned Rule no. 9.

The system of registration of companies appears to be somewhat similar to that of the proposed Federal Securities Code in the U.S. As a matter of fact, the central concept of disclosure in the Code is the requirement of registration of companies rather than of securities [3].

According to a recent interpretation by the CVM [4], Law no. 6.385/76

created three different registrations: (1) registration of the company and simultaneous registration of its primary distribution; (2) registration of securities to be traded on a stock exchange; and (3) registration of securities to be traded on the over-the-counter market. The first registration, according to the CVM, is basically for primary distributions, but it may be required for secondary distributions when the seller is the controlling shareholder or the underwriter. There would be no need for registration of a secondary distribution, however, if effected on a stock exchange. The CVM believes that the registration of securities to be traded on a stock exchange is sufficient to protect investors, unless there is block trading. In that case the broker and the stock exchange must observe a “special proceeding”, which is not defined by law.

Three important innovations must be mentioned. First is the creation of a “Director of Relations with the Market”. Section 11 of CVM Rule no. 9 establishes that in order to be registered with the CVM, companies must have a director whose specific task is to disclose information to the CVM and to investors, as well as to update the registration of the company. The existence of this Director of Relations with the Market does not eliminate the responsibility of all other directors with regard to the prompt disclosure of relevant information.

A second innovation is the introduction of the notion of “soft information” in the process of disclosure [5]. As a rule, according to Instruction no. 9, section 14, forecasts, if disclosed, must be clear; and if they are no longer valid, directors must disclose this fact to the market.

Third is the creation of a “guaranty of access” to all investors in a public offer. Section 31 of CVM Rule no. 13 establishes that the issuing company and the underwriter must disclose whether or not there will be a guaranty of access to all potential buyers. Though not mandatory (and this deserves some criticism), the provision is the first measure to improve equal access by all investors to “hot issues”, which are usually bought up by financial institutions or other sophisticated and powerful investors.

3. Insider trading regulation

An important development contained in the Corporations Act concerns the rules restricting insider trading. Though this subject had occasionally been mentioned in previous legislation [6], a clear definition of insider trading was lacking. The main provisions regarding insider trading restrictions are section 155, paragraph 1, and section 157, paragraph 4.

Section 155, paragraph 1 states that a director of a publicly-held company must withhold “... any information not yet publicly disclosed, obtained by virtue of his position and which is able to materially affect the market price of

securities, it being unlawful to make use of such information to obtain for himself or for third parties, any advantages in connection with the purchase or sale of securities". In paragraph 2 of section 155, the Act establishes that the director must be sure that no violation of the provision of paragraph 1 occurs through an action of a subordinate or a third party in his confidence. And according to paragraph 3 of the same section "any person suffering damages from the purchase or sale of securities carried out in violation of the provisions of paragraph 1 and 2, above, is entitled to indemnification for losses and damages, provided that the information was unknown to him at the time of the transaction".

Section 157, paragraph 4, establishes that "directors of a publicly-held company must immediately inform the Stock Exchange and disclose through the press any resolution taken by management or by the shareholders at a General Meeting or any relevant fact which occurs in its business affairs which may substantially influence the decision of market investors to sell or buy securities issued by the company".

The Brazilian Corporations Act adopts a "standard of loyalty" with reference to the conduct of directors of publicly-held companies. This standard of loyalty is based on the fiduciary duty of the corporation's directors.

Under the Brazilian, law insider trading means any acquisition or sale of securities by a director of a publicly-held company or by a "tippee" who received the tip from an insider within the period of time when the material information was not disclosed [7]. According to the Corporations Act, "insiders" are managers, members of the Board of Directors, members of the Fiscal Council, the Controlling Shareholder, and other employees who, due to their position, may have access to material information.

The prohibition against insider trading can also be applied to investors in general, as well as to financial institutions, according to CVM Rule no. 8/79. This rule prohibits directors and stockholders of publicly-held companies, financial institutions, and other participants in the market from creating false markets, or manipulating, or using non-equitable practices in their tradings. Also, according to said rule, the notion of "non-equitable practice" may be applied to all persons referred to above.

Two types of measures may be taken against insider traders. First, there is ample provision for administrative penalties by the CVM: reprimand, a fine of up to as much as 500 times the value of an Indexed Treasury Bond (about U.S. \$12.00) or 30% of the amount of the transaction; and in the case of recurrence or serious violations, the CVM may suspend or even disqualify directors of publicly-held companies and financial institutions. Secondly, injured investors may bring suit to recover damages caused by the insider's actions. In such a case, or in any other suit based on corporate and securities laws, the Securities Commission must be called by the judge to act as *amicus curiae*.

The introduction of the *amicus curiae* was an important innovation in Brazilian law. In fact, no other regulatory agency in Brazil has a similar power. The only other administrative body with a similar attribute is the Public Attorney. According to Law no. 6.616, December 16, 1978, in suits involving securities legislation or regulation of publicly-held companies, the CVM must be called to give an opinion. This agency is also entitled by the Law to appeal to an upper court if neither of the interested parties does so.

The ability of the CVM to act as an *amicus curiae* is a measure designed to overcome a difficulty in the Brazilian Securities Regulatory System, which concerns the application of its legal provisions by the courts. In general, judges are not familiar with corporate law and securities regulation. As we can see in the Servix case – the first case to deal with insider trading restrictions – there is a long way to go if the major innovations of corporate and securities law are to be enforced by the courts.

4. The Servix case

The Servix case began between March 28 and March 31, 1978, with the irregular sale of Servix shares on the São Paulo Stock Exchange. Since the beginning of the year, shares of the company had been traded in increasing quantities and at rising prices. This fact was amply disclosed by the Press and justified by the possibility that Servix might win the public bid for construction of a dam for a state-owned light and power Company named Hidroelectrica de São Francisco (CHESF). At the end of March, strong selling pressure caused the sales volume to rise, without further explanation, from 796 thousand shares on the 28th to 14.7 million shares on the 31st. Not until April 3 was CHESF's decision to cancel the public bid communicated by Servix's financial director to the São Paulo Stock Exchange. This decision had been transmitted to Servix on March 28. Following the suspension of trading in Servix shares and the initial disclosure of the transactions concluded between March 28 (cancellation of the public bid) and March 31 (suspension of trading in the São Paulo Stock Exchange), various transactions in the shares of Servix involving its employees and directors were found to have occurred. This fact was communicated to the CVM which, in turn, initiated an administrative proceeding.

The fundamental issues addressed in the CVM proceeding were (1) withholding of material facts; and (2) dealings in securities by persons having access to material information regarding such securities. With reference to the former, the CVM, after emphasizing the duty of immediate disclosure of material information, stated that "the public must have the opportunity to make its investment decisions through use of the best available information, thereby guaranteeing efficient allocation of resources in the market and [thus] reducing the possibility that certain persons might benefit, at the cost of others, by

means of privileged access to information as yet undisclosed". In this manner the CVM established the parameters of the duty of immediate disclosure of material information. Thus, in order to establish whether a particular item of information is or is not relevant, a director should cast himself in the role of "an ordinary investor and determine whether the information would affect his decision to sell, buy, or retain his shares" [8]. Admitting, furthermore, "the possibility that legitimate reasons exist for temporary withholding of material information", the CVM concluded that the nondisclosure of a material fact should occur only when there is full consciousness of the true implications of a failure to disclose "and when [such secrecy] is accompanied by proper safeguards".

Emphasizing that "there exists no circumstance in which a director of a company may trade in shares, when, by virtue of his position, he possesses information which his counterpart does not have", the CVM ends its decision by asserting that it is unnecessary "that there be shown fraud on the part of the director in negotiating his shares, it being sufficient that the negotiation is carried out while in possession of material information unknown to the other party, in order that [such director] be subject to punishment by the CVM". Thus, according to the interpretation adopted by the CVM, it is sufficient that there be proven a breach of the duty of loyalty in order to trigger the director's responsibility. There exists, then, a legal presumption of liability under such circumstances.

In its final decision in the case, the CVM issued a reprimand to the managers of Servix for their failure to disclose material information. In addition, it imposed a fine on its president for engaging in insider trading. Subsequently on appeal to the National Monetary Council (CMN), CVM's decision was upheld.

At the present time, the Servix case is being litigated in the courts in three separate suits, which have already been tried in the lower courts.

Among the difficulties arising from the varying judicial analyses in *Servix*, there stands out the problem of evidentiary proof of the occurrence of insider trading. According to a study carried out by the Legal Department of the CVM [9], the nature of insider trading brings one to believe that legal presumptions should play a relevant role in proving its existence. Thus, a judge may presume the occurrence of an illegal act based on evidentiary facts, such as, for example, purchases or sales of shares of a specific company by an insider immediately before the disclosure of a material fact. However, as will be shown by the cases, this has not been the understanding of the majority of judges.

A decision handed down by the judge of the 9th Division of the Federal Court on September 10, 1980, overturned the Servix decision of the CVM. The federal judge's ruling was based on a lack of evidentiary proof of bad faith on the part of the president of Servix. There existed, to the contrary, "[an] official

document demonstrating that the news had come to his attention only after he had decided to sell the shares". Thus, believing that the fundamental point at issue was whether, in reality, the president of Servix had knowledge of the cancellation of bid before he sold his shares of Servix, the judge found, based on the documentation presented, that "... if the announcement officially came to the defendant only on April 6, 1978, there is no way to prove, through hearsay, that the same announcement had arrived unofficially on March 28, 1978. [Thus] the defendant is relieved of the stigma of dishonesty in the administration of the shares of Servix" It is evident that the legal reasoning adopted by this judge differs substantially from that employed by the CVM, which considered irrelevant the point at which the directors officially had knowledge of the cancellation of the bid. Accordingly, the CVM established as a basic principle in the characterization of insider trading the fact that there exists no "circumstance in which a director of a publicly-held company may trade in shares when by virtue of his position he possesses information which his counterpart does not have"

In similar fashion, the decisions reached in two separate civil suits brought in São Paulo for damages against the then president of Servix by minority shareholders are absolutely irreconcilable. The judge of a lower state court in a decision of March 10, 1980, concluded that "the defendant, president of Servix, had violated Section 155, ¶1 and Section 157, ¶4 of Law 6.404, by not disclosing a material fact [regarding the company] and furthermore by taking advantage of privileged information in order to obtain an advantage for himself through the sale of equity securities to the detriment of the buyer...." On the other hand, the judge of another state court, on November 13 of the same year, reached a substantially different result. Analyzing the legal parameters of insider trading, he came to the conclusion that paragraph 3 of Section 158 "is, in the commercial field, the twin brother of Section 159 of the Civil Code (the section dealing with general liability)" and declared the suit to be improper for the plaintiff's failure to "prove that the defendant practiced insider trading".

The decisions discussed above serve to demonstrate the difficulties that are still encountered by the judiciary in deciding cases involving insider trading. The adoption by the courts of new concepts found in the field of securities regulation has proven to be slow, and judges tend to center their analyses around basically formal questions. Such tendencies make it difficult to accurately appraise the damage inflicted upon the securities market by the practice of insider trading.

Notes

[1] Law No. 6.404, December 15, 1976.

[2] Eizirik, *The Role of the State in the Regulation of the Securities Markets: The Brazilian Experience*, 1 J. Comp. Corp. L. & Sec. Reg. 211 (1978).

- [3] See Bialkin, *The Issuer Registration and Distribution Provisions of the Proposed Federal Securities Code*, 30 *Vanderbilt L. Rev.* 327 (1977).
- [4] In the decision of Administrative Proceeding No. 04/80, October 10, 1980, known as the "Caso Vale".
- [5] For the American system, see Newton Sérgio de Souza, *Disclosure of Soft Information: Trends and Developments* (manuscript) (available at the Center for Study of Financial Institutions, University of Pennsylvania Law School).
- [6] Law No. 4.728, June 14, 1965, known as the Capital Markets Law.
- [7] M. Carvalho, *5 Comentários à Lei das Sociedades Anônimas* (1981).
- [8] The interpretation adopted by CVM was influenced by the Court's decision in the famous Texas Gulf Sulphur case.
- [9] N. Parente, *Aspectos Jurídicos da "Insider Trading"*, *Legis Bancos, Informativo CVM*, part 4.