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BRAZIL: RECENT CORPORATE GOVERNANCE ADVANCEMENTS AND RETREATS

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ABSTRACT

This article overviews recent developments and set backs in the regulation and self-regulation of Brazilian corporate governance. Ownership transitioned from concentrated control dominance to a mixed pattern of a substantial minority of companies with shared control under shareholder agreements and a few dispersed ownership companies. Recent statistics suggest a reversal in this trend with the increase in concentrated control companies. Companies that once embraced premium trading lists that required better corporate governance practices resisted a tightening of this self-regulation and some successfully and lawfully did not comply with new compensation disclosure regulation. Many companies have gone back private. Institutional investors, in general, did not show an effective contribution to corporate governance improvement in their investees and the largest ones face serious internal conflict of interest issues.

Keywords: ownership structure; listing requirements; compensation; disclosure; institutional investors; corporate governance; Brazil

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RESUMO

Este artigo examina avanços e recuos recentes na regulamentação e auto-regulação das práticas de governança corporativa no Brasil. Os direitos de propriedade passaram da dominância do controle concentrado para um padrão misto com uma minoria substancial de companhias com controle compartilhado sob um acordo de acionistas e algumas empresas com propriedade dispersa. Estatísticas recentes sugerem uma reversão dessa tendência com o aumento de companhias com controle concentrado. Empresas que um dia abraçaram os segmentos de listagem prêmio que exigiam melhores práticas de governança corporativa resistiram a um robustecimento desta auto-regulação e algumas não cumpriram as novas regras de transparência acerca da remuneração com sucesso e respaldo legal. Muitas companhias fecharam o capital. Os investidores institucionais, em geral, não contribuíram efetivamente para a melhoria da governança corporativa nas firmas em que investem e os maiores enfrentam sérios problemas internos de conflitos de interesse.

Palavras-chave: direitos de propriedade; exigências de listagem; remuneração; transparência; investidores institucionais; governança corporativa; Brasil

1 – INTRODUCTION

This article discusses developments in Brazilian corporate governance practices, with an emphasis on recent transformations and the institutions that took part in them. This introduction is followed by a discussion of the partial reshaping of the concentrated ownership model towards a mixed and hybrid system. The important introduction of premium trading lists at the stock exchange and the attempts to reform them comes next. These premium-trading lists require that the companies that voluntarily join them abide to certain corporate governance and disclosure practices. Attempts to strengthen the requirements were only partially successful. Next the article addresses compensation levels, new rules to improve and expand compensation disclosure and the legal resistance to comply with them. Finally, a brief analysis of institutional investor engagement in Brazil and its muddled effects closes the article. The text highlights the most relevant institutions taking part of the events and their stance in most instances.

A picture of the recent evolution of corporate governance practices is presented in Leal, Carvalhal, and Iervolino (2015) who analyse a Corporate Governance Index (CGI) of Brazilian publicly traded companies between 2004 and 2013. The CGI series starts in 1998 and has been calculated annually since then for each company traded on the exchange. Leal and Carvalhal da Silva (2007) proposed the original CGI version with objective questions that could be responded from publicly available information simply with a "yes" or "no".

Leal *et al.* (2015) state that the overall corporate governance quality improved, especially after the stock exchange created the premium corporate governance trading lists. However, the average score of the index levelled in the last few years of their sample. They say that the average CGI of 5.8 (out of 10) in 2013 is low and suggest that there is room for improvement. Questions related to ethics and conflicts of interest achieve much lower scores than the other sets of questions regarding transparency, composition and functioning of the board and shareholder rights. The authors underline their concerns about the very small number of firms that ban loans to related parties or facilitate participation in shareholder meetings. They claim that lesser use of mechanisms to increase control, such as non-voting shares and indirect control structures, was a notable advance. Still, agreements among shareholders were more frequently used to interfere with the independence of directors and enhance the power of the controlling block.

This article proceeds with sections discussing the emergence of a hybrid ownership model, a partially successful attempt to reform premium listing rules, recent developments and legal battles about compensation disclosure, and closing with the inconclusive effects of the entanglements of institutional investors with their investees in Brazil.

2 – THE RISE OF A HYBRID MODEL OF CORPORATE GOVERNANCE

Brazil has been perceived as a low investor protection country. In the 1990s it certainly presented under developed corporate governance practices, typical of a highly concentrated ownership emerging economy, with many large firms controlled by families and the state, passive boards submitted to the will of controlling shareholders, widespread use of indirect control structures, and a very high percentage of non-voting shares in the equity capital of listed companies. Leal, Carvalhal and Valadares (2002) pointed out that the largest shareholder would hold a relevant share of the voting rights even in cases where there was no controlling shareholder. They also reveal that in those cases the three largest shareholders controlled companies, often pooled under an agreement, and that they often used pyramid schemes as a mechanism to warrant control at a lower cost.

Yet, Silveira (2009) indicated that several domestic developments began to change this scenario in 2004, notably the surge in Initial Public Offerings (IPO) to list in *Novo Mercado*, one of the newly created premium listing segments of the stock exchange, in which all shares must be voting and companies need to comply with an assortment of corporate governance practices beyond legal requirements. The author asserted that Brazil faced a substantial shift in ownership structure in the ensuing years. An expressive minority of companies begins to display lower control concentration levels and a few could even be characterized by dispersed ownership and management control. This reconfiguration brought about important changes in the structure and practices of boards of directors, improved the disclosure and quality of company information, and potentially enhanced investor protection. A new hybrid model of ownership surfaced, in which a large minority of companies typically had a shared control group formalized under an agreement of shareholders, instead of a clear controlling shareholder.

Still, Sternberg, Leal and Bortolon (2011) stated that the overall concentration of control rights remained very high, even though it was significantly lower in the aforementioned premium listing segments. Furthermore, the authors evinced that agreements among shareholders became more frequent with the reduction in control concentration, regardless of the existence of a controlling shareholder. Carvalhal (2012) said that the role of shareholder agreements in mitigating potential conflicts of interest among controlling and minority shareholders was positively related to firm value and could produce a better degree of investor protection. On the other hand, Gelman, Castro and Seidler (2015) claimed that the impact of shareholder agreements on firm value in Brazil is negative when the vote of directors is bound in a generic fashion to the will of the signatories. This effect becomes positive when there is binding exclusively for specific issues. They maintain that Carvalhal (2012) optimistically evaluated the role of shareholder agreements because most minority shareholders do not take part in it and the controlling group of shareholders may still subject them to expropriation.

Brazil faced a serious economic crisis in 2014-2016, which seems to have interrupted the decreasing trend in control concentration. The number of companies with major shareholders owning more than 50 per cent of the voting shares rose from 41 per cent in 2014 to 47 per cent in 2015. Accordingly, the percentage of companies with minority or shared control dropped from 54 to 49 per cent in the same period (Capital Aberto, 2015). The lower stock prices following the domestic economic slowdown became an incentive to acquisitions, which in turn led to a reduction in market free float, possibly increasing control concentration. Many public companies were acquired and then went private. Others simply delisted because they no longer saw advantages in the costs of remaining public. Some companies abandoned the premium lists for the first time. In

tandem with these events, a policy of greater state intervention in the economy, both as financier and provider of selective economic incentives, reduced the role of capital markets. These new events brought about old challenges to continuous corporate governance practices improvement and gave way to a reenergized control concentration trend.

3 – PREMIUM LISTING REQUIREMENTS REFORM

Maybe it is in difficult times that new opportunities shape up, says the old cliché. Back in 2000, The Securities, Commodities, and Futures Exchange of Brazil (BM&FBovespa), the unified stock exchange of the country, was facing a very serious threat when Brazilian companies were listing their American Depository Receipts (ADRs) in the US and trade revenues were flowing away. The exchange responded with the launch of differentiated corporate governance listing segments in December 2000. The three new premium levels – Levels 1 and 2 and *Novo Mercado* – demanded corporate governance and transparency practices over and above the requirements in the Brazilian Corporate Law and in the complementary regulations issued by the Brazilian Securities Commission (*Comissão de Valores Mobiliários* – CVM).

These premium segments are a private initiative in order to improve the credibility of Brazilian public companies and capital market. They are an opt-in system, in which the joining companies voluntarily elect to comply with higher corporate governance and disclosure standards. These premium lists are an alternative between a more detailed, and less flexible, law, which is obviously mandatory, and corporate governance codes, which in Brazil are recommendations that are not subject to comply or explain rules. The introduction of three new premium lists with increasing demands also contributed to latitude. Yet, migration was only partial, as many companies remained listed in the old listing segment that came to be called "traditional". Newly listed companies embraced the premium lists, especially between 2004 and 2007.

Level 1 demands that companies improve the disclosure and increase the dispersion of their shares by means of several specific requirements. A company must agree to all the obligations of Level 1 and adopt an additional broader range of corporate governance practices involving the board of directors and rights for non-voting shares to list in Level 2. Moreover, companies must abide to quicker dispute resolution through arbitration. *Novo Mercado*, the most demanding premium segment, calls for the company to comply with all the requirements of Levels 1 and 2 in addition to solely issuing voting shares. Hence, the main distinction between Level 2 and *Novo Mercado* is the ban of non-

voting shares in the latter. The Brazilian corporate law does not allow different voting rights among common shares; thus, the one-share-one-vote principle is a *Novo Mercado* requirement. Carvalhal (2012) describes the three premium segments in detail. The interested reader may also exam them at the BM&FBovespa website.

Following its very successful years between 2004 and 2007, BM&FBovespa initiated discussions to reform the premium listing rules in 2008. The natural evolution of corporate governance practices around the world, especially with legislation introduced elsewhere in the aftermath of the global financial crisis in 2008, and the steady development of Brazilian regulation, such as the mandatory adoption of the International Financial Reporting Standards (IFRS) and the introduction of a much more comprehensive and detailed format of information reporting to CVM that came into effect in 2009, which required more transparency about many aspects, such as related party transactions, compensation, and internal controls, motivated the exchange. Multi-billion dollar losses from some high-profile Brazilian listed companies due to derivatives transactions after the emergence of the global financial crisis and the consequent need to strengthen market credibility also encouraged the reform process. It took more than two years to conclude the process in which companies listed in the premium segments voted on ten reform proposals and rejected three of them. Table 1 details the three proposals that have been rejected.

The promoters of the stock exchange rules reform considered these three rejected proposals very important and there was a sense of frustration about many of the companies already in the premium listing segments turning them down. Were these companies really committed to better corporate governance practices? Silveira (2010) alleges that the answer may be in the nature of their controlling shareholders. Family firms controlled by founders or heirs have historically preferred to improve only the minimum necessary in their corporate governance practices, as noted by the author. He also points out that the presence of relevant institutional investors was not material to inhibit the attitude of these companies regarding the rejected proposals.

Table 1 – Rejected Novo Mercado reform proposals

Proposed rule	Detail	Segment	Votes for / abstentions	Votes against
Composition of the Board of Directors	For Novo Mercado and Level 2: Increase from 20 to 30 per cent the number of independent board members For Level 1: minimum of five board members of which at least 20 per cent must be independent members	*Novo Mercado*	51 (48.6%)	54 (51.4%)
		Level 2	11 (57.9%)	8 (42.1%)
		Level 1	17 (48.6%)	18 (51.4%)
Audit Committee	Requirement for an audit committee comprised of a minimum of three members elected by the Board of Directors, of which at least one must be an independent board member. Three-year deadline for conforming to the new rule.	*Novo Mercado*	44 (41.9%)	61 (58.1%)
		Level 2	12 (63.2%)	7 (36.8%)
		Level 1	14 (40.0%)	21 (60.0%)
Takeover bid through substantial acquisition of shares (proposal for Novo Mercado only)	Mandatory bid rule applicable in the hypothesis of a shareholder (alone or acting in concert with others) hitting 30 per cent ownership threshold. In this case, he or she would have to make an offer to buy all outstanding shares for a price equivalent to the highest share price paid by the acquirers in the past 12 months.	*Novo Mercado*	45 (42.9%)	60 (57.1%)

The recent Brazilian economic set backs and the reduced capital market relevance once again motivated the exchange to seek improvement in corporate governance practices as a way out of the crisis. BM&FBovespa presented a new plan to reform *Novo Mercado* rules in 2015. They sought the support of foreign investors, which are increasingly important in the domestic stock market, and will submit the proposals to a

public hearing in the beginning of 2016 (REUTERS BRASIL, 2015). They hope that companies are truly committed with better corporate governance practices and are not simply seeking a label while posing with weak fundamentals. It is also worth noting that many companies have recently delisted from the premium segments and the exchange altogether. There was one case of a company delisting from *Novo Mercado* to trade in the traditional segment, and of companies going public and listing in the traditional segment, disdaining *Novo Mercado*. Curiously, the controlling shareholder of one of these traditional listings, a financial institution, was jailed afterwards on charges of obstruction of justice and corruption in dealings with the government and political parties in a major corruption investigation under way in Brazil that has reached into the highest posts of the republic. Thus, the time for a new reform is probably due.

4 – COMPENSATION DISCLOSURE

CVM introduced a new regulation in 2009 that significantly expanded what companies should disclose in their annual information report, including all sorts of compensation details, among many other topics. Before the introduction of the new compensation disclosure demands, Brazilian companies used to provide only very general information about their compensation policy and solely disclose the total amount expected to be paid to the board of directors and top management team altogether. The instruments and policies used to divide and pay this amount was not disclosed and shareholders only approved this lump sum as a kind of annual budget. This usually did not represent a practical problem because companies had a controlling shareholder with the necessary votes to approve. This meeting of shareholders practice remains even under the new regulation. However, there have been a few recent cases in which shareholders rejected the usual lump sum proposal on the condition that the board should present more details.

Compensation may be related to performance in Brazil. Carvalhal and Chien (2013) studied compensation in 420 Brazilian listed companies between 2002 and 2009, before the introduction of the new compensation disclosure rules. They claim a significant and positive relationship between total compensation and performance.

Pinto and Leal (2013) studied compensation after the introduction of the new disclosure rules in 2009. They conclude that Brazilian firms with no controlling shareholder or coalition pay an average of 79 per cent more to senior managers, twice more to the chief executive officer (CEO), and 80 per cent more to the board of directors. The authors also analysed the compensation characteristics of family firms. In those cases, CEOs

receive 43 per cent more and the compensation of the board of directors increases proportionally to family membership in the board. On the other hand, they surmised that companies with a lower degree of ownership concentration pay higher compensation to top executives and that company size and the identity of controlling shareholders also seem to be compensation determinants in Brazil.

The Brazilian Institute of Corporate Governance (*Instituto Brasileiro de Governança Corporativa – IBGC*) has been producing occasional surveys about the compensation of board members and senior management. The most recent report (IBGC, 2015), with data from 2013, shows that the median annual individual compensation in the board of directors is about R$ 144,598 (US$ 29,597) and the maximum goes past R$ 14 million (US$ 3,615,702). Some board members, especially those associated to the controlling families, may earn much more than other directors. In comparison with 2012, in general the median compensation rose 11.7 per cent. Yet, the median of companies listed in the premium segments decreased, especially due to a reduction in the variable compensation paid to board members.

There was also a growth of 12.3 per cent in the median compensation of senior management in the same period. The median annual compensation was about R$ 1,234,877 (US$ 318,925) and the maximum was over R$ 13 million (US$ 3,357,438). A reduction in the variable compensation was reported for companies listed in the premium listing Level 2 and in the traditional segments. According to the report, Brazil does not show a frequent use of variable compensation to board members because almost 80 per cent of the companies pay solely fixed compensation. This is different with senior managers, as merely 24.4 per cent of companies pay fixed compensation exclusively. A significant majority of companies uses a package that combines fixed, variable, and stock compensation to pay senior managers, following usual international practices.

The new compensation disclosure rule introduced in 2009 was not well received by many companies. Even though the new rule only demanded that the average, minimum, and maximum compensation was disclosed, without associating individual board and senior management members to their compensation packages, the reaction came swiftly in the form of a preliminary court injunction secured by the Brazilian Institute of Financial Executives (*Instituto Brasileiro de Executivos Financeiros* - IBEF) in 2010. This institution has members in virtually every public Brazilian company and is representative of the professionals they employ.

IBEF claimed that disclosing the maximum compensation singled out the most important individuals in the company, exposing them to criminals and to a greater risk of kidnapping, which is in violation to basic constitutional safety and privacy rights. A federal

court granted the injunction, CVM appealed, and a higher court upheld the lower court decision. Companies now had a legal option of non-compliance with the rule until a final decision on the matter is reached, what could easily take more than a decade.

This event is another illustration of the set backs suffered by promoters of good corporate governance practices in Brazil and investors in general. It also provides a concrete example of how the slowness of the Brazilian judiciary may be used to hinder the adoption of certain corporate governance practices. On the positive side, the number of companies using the injunction has decreased, with growing pressures from not-for-profit organizations such as IBGC and the Association of Capital Market Investors (*Associação de Investidores no Mercado de Capitais* - AMEC), an organization of domestic and foreign asset managers, that also includes some well known foreign pension funds like Calpers. Yet, this figure was still around ten per cent of listed companies by the end of 2015, including some of the largest financial, industrial, and commercial companies in the country, a few of them operating important governmental concessions.

Research about this injunction by Barros, Silveira, Bortolon, and Leal (2015) showed that there was no association between crime levels in the state the companies are headquartered and the probability of non-compliance with the new rule. Non-compliance, on the other hand, was associated with ownership concentration, company size, and poorer corporate governance practices and performance. Compliance was more frequent among companies controlled by the state and foreign entities. These authors performed an event study and allege that shareholders were surprised when some companies with good ex-ante corporate governance quality scores became non-compliers. On the other hand, they were not caught off guard when companies with a poorer corporate governance track record used the injunction to avert compliance.

5 – INSTITUTIONAL INVESTORS

Institutional investors hold more than five per cent of the voting shares in about half of the larger publicly traded Brazilian companies, which correspond to about 99% of the market value (OECD, 2013). Many believe that the presence of institutional investors spurs the improvement of corporate governance practices due to their presumed ability to nudge investee companies in the right direction, through their engagement with management, voting and proposing in the meetings of shareholders, or board membership, for example. Yet, there is a gloomy side to institutional investor ownership. They may align with management or the controlling shareholders of companies and act in detriment of the minority, even when they are part of it. One example is institutional investors whose parent

entity is a state-owned company. They may align with the political orientation of government appointees even when their acts are harmful to the interests of those they represent. Institutional investor engagement in Brazil is still considered low, perhaps more out of concern for protecting themselves from expropriation by dominant shareholders than for disciplining such stakeholders.

A recent and elucidative case involved several institutional investors connected to the Brazilian federal government. The three largest pension funds in the country are: Petros (sponsored by Petrobras, Brazil's oil giant and largest company); Previ (sponsored by Banco do Brasil, Brazil's largest bank); and Funcef (sponsored by Caixa, Brazil's third largest bank). The federal government controls these three companies. CVM fined the three pension funds in early December 2014 for voting on candidates for the board representation of the minority shareholders of Petrobras in 2011 and 2012. The CVM commissioners concluded that the federal government, the largest shareholder of Petrobras, interferes in the decision making process of these pension funds as well. Thus, they cannot be considered independent minority shareholders, but acquiesce in the federal government's proposals. *Banco Nacional de Desenvolvimento Econômico e Social* (BNDES) and *BNDES Participações* (BNDESPAR), both giant development institutions controlled by the federal government, settled with CVM under the same proceedings. On the positive side, one must note that CVM commissioners, also nominated by the federal government and approved by the senate, acted independently to curb the abuse.

The previous case may hint at why the evidence concerning the influence of institutional investors on the corporate governance practices of Brazilian companies is inconclusive. Most Brazilian pension funds hold very minor equity positions because yields on debt securities have outclassed the stock market performance in the last twenty years. Brazil boasts one of the highest interest rates in the world. The largest pension funds, those controlled by the federal government, contrast with the majority because they are among the few with notable equity holdings. Maybe this is at the root of why pension funds have displayed negative or no relationship with the quality of corporate governance practices (PUNSUVO *et al.,* 2007; OLIVEIRA *et al.,* 2012). The few that are important equity holders may display a muddled behaviour given their conflict of interest regarding some relevant investees.

The performance of BNDES is also often questioned as some authors allude that their loans are not necessarily extended to companies showing better corporate governance practices (SILVEIRA, 2011; LAZZARINI and MUSACCHIO, 2011). It is possible that the political entanglements of these institutions translate into a lack of clarity on the effects of their engagements with investees. On the other hand, private institutions rarely engage with management, at least in the public fashion many US activists do. Even so,

there is some evidence that private equity and mutual funds may lead to improvements in corporate governance practices when they engage management (SILVEIRA, 2010).

Institutional investors should keep their independence from investees or should be barred from investing in companies in which conflicts of interest may arise. An institutional investor may act as an independent minority shareholder for an investee, taking steps in favour of their beneficiaries, and simultaneously act in concert with controlling shareholders of another investee, but harmfully to its beneficiaries. This aspect may be particularly relevant in the Brazilian context where the largest institutional investors are controlled by the state. Regulatory initiatives to increase the power of institutional investors must address these conflicts of interest issues. The nomination process for the board and senior management of institutional investors should strive to select independent individuals.

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