



THE WORLD BANK

# Report on the Observance of Standards and Codes (ROSC)

## Corporate Governance

# Corporate Governance Country Assessment

Brazil

May 2005

# Overview of the Corporate Governance ROSC Program

## WHAT IS CORPORATE GOVERNANCE?

Corporate governance refers to the structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital.

The *OECD Principles of Corporate Governance* provide the framework for the work of the World Bank Group in this area, identifying the key practical issues: the rights and equitable treatment of shareholders and other financial stakeholders, the role of non-financial stakeholders, disclosure and transparency, and the responsibilities of the Board of Directors.

## WHY IS CORPORATE GOVERNANCE IMPORTANT?

For emerging market countries, improving corporate governance can serve a number of important public policy objectives. Good corporate governance reduces emerging market vulnerability to financial crises, reinforces property rights, reduces transaction costs and the cost of capital, and leads to capital market development. Weak corporate governance frameworks reduce investor confidence, and can discourage outside investment. Also, as pension funds continue to invest more in equity markets, good corporate governance is crucial for preserving retirement savings. Over the past several years, the importance of corporate governance has been highlighted by an increasing body of academic research.

Studies have shown that good corporate governance practices have led to significant increases in economic value added (EVA) of firms, higher productivity, and lower risk of systemic financial failures for countries.

## THE CORPORATE GOVERNANCE ROSC ASSESSMENTS

Corporate governance has been adopted as one of twelve core best-practice standards by the international financial community. The World Bank is the assessor for the application of the OECD Principles of Corporate Governance. Its assessments are part of the World Bank and International Monetary Fund (IMF) program on Reports on the Observance of Standards and Codes (ROSC).

The goal of the ROSC initiative is to identify weaknesses that may contribute to a country's economic and financial vulnerability. Each Corporate Governance ROSC assessment reviews the legal and regulatory framework, as well as practices and compliance of listed firms, and assesses the framework relative to an internationally accepted benchmark.

- Corporate governance frameworks are benchmarked against the OECD Principles of Corporate Governance.
- Country participation in the assessment process, and the publication of the final report, are voluntary.
- The assessments focus on the corporate governance of companies listed on stock exchanges. At the request of policymakers, the ROSCs can also include special policy focuses on specific sectors (for example, banks, other financial institutions, or state-owned enterprises).
- The assessments are standardized and systematic, and include policy recommendations. In response, many countries have initiated legal, regulatory and institutional corporate governance reforms.
- Assessments can be updated to measure progress over time.

By the end of June 2005, 48 assessments had been completed in 40 countries around the world.

# REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

## Corporate governance country assessment

Brazil

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### Executive Summary

**Achievements/Progress since previous assessment:** Brazil today is at an advanced stage in the corporate governance debate, and demand for voting shares, transparency, tag along rights and other corporate governance rights has increased significantly. As a result, share offerings take place on the special listing segments rather than on the main board. Enforcement has improved substantially, as the securities regulator, CVM, enforces laws and regulations in a consistent and predictable fashion. The private sector took the initiative to provide incentives that would bridge the gap between the existing legal framework and best practice for issuers who want to distinguish themselves in the competition for capital at home and abroad. BOVESPA introduced special listing segments requiring progressively stricter corporate governance standards. These have given investors a benchmark against which to measure corporate governance.

Despite the legal reforms of 2001, gaps remain, especially with respect to shareholder protection and financial reporting.

**Key obstacles:** While Brazil has the largest capital market in Latin America, it does not represent the attractive financing source one would expect in a country of its sophistication. High interest rates are not the only reason. The ownership structure continues to be highly concentrated, with families, financial/industrial groups or small numbers of shareholders acting in concert exercising control. The high proportion of non-voting shares increases the potential for expropriation of minority shareholders and represents a structural obstacle towards reform.

**Next steps:** CVM, BOVESPA, IBGC and firms listed on the Novo Mercado have been major champions and drivers of change. The challenge now is to “mainstream” corporate governance reform beyond this limited group of insiders and make it an integral part of the investment climate agenda.

## **Acknowledgements**

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## Country assessment: Brazil

*Market capitalization to GDP has grown significantly over the past three years*

The Brazilian equity market is catching up both in terms of size and depth with capital markets in other middle income countries, such as Chile, China, or India. While for several years the only new offerings had been debentures, equity issues started experiencing a come-back in 2004.

*The “Novo Mercado” is gaining in importance and prominence*

The fact that public share offerings are taking place on the corporate governance segments shows that investors are becoming more sophisticated and value corporate governance in their investment decision.

*The legal framework is adequate, but gaps remain*

The corporate and securities legal frameworks were partially overhauled in 2001, but gaps remain, especially with respect to investor protections and reporting requirements.<sup>1</sup> Company law is based on French civil law; securities law has some common law influence.

*Key players include the Brazilian Institute of Corporate Governance and pension funds*

Key institutions include the securities regulator (CVM), the stock exchange (BOVESPA)<sup>2</sup> and the Brazilian Institute of Corporate Governance (IBGC). Pension funds and corporate governance mutual funds are the most active institutional investors. In addition, BNDES, the state owned development bank and the main source of long-term financing, is another important potential driver for change.

### Progress since previous assessment

*Increased IPO activity on Novo Mercado and Level II suggests that BOVESPA has successfully made the business case for corporate governance*

Corporate and securities law reforms in 2001 and subsequent enabling legislation represented an important step towards more disclosure and protection for minority shareholders. However, some of the important elements of corporate governance reform, especially those regarding minority shareholder protections and better disclosure rules had to be watered down significantly, in order for Congress to approve the package. Because of the limitation to implement certain improvements through legislative reform, the stock exchange (BOVESPA) created a mechanism of voluntary adhesion to good corporate governance practices. The creation of special listing segments was an attempt to make the business case for good corporate governance. There are now signs that this effort is paying off – out of the seven initial share sales in 2004, five companies listed on the highest corporate governance segment (*Novo Mercado*); and the remainder on *Level II* (in both cases granting 100 percent tag along rights to minority shareholders).

*Awareness of importance of corporate governance increased*

IBGC has worked for ten years to improve awareness of the importance of good corporate governance among listed and unlisted firms. Today, Brazil is at an advanced stage of the corporate governance debate and firms are aware that this is an important issue. Corporate actions that are perceived as harmful to minority investors carry reputational risks and the threat of investigation by the securities regulator, CVM.

*CVM has become a*

The 2001 legal reforms elevated CVM to the level of independence of other

<sup>1</sup> Laws 10,303/01 and 10,411/02 amending the Corporation and Securities Laws and CVM regulations.

<sup>2</sup> Bolsa de Valores de São Paulo (Sao Paulo Stock Exchange).

*more independent,  
active and credible  
regulator*

regulatory agencies with fixed managers. This has made it possible for CVM to hire professional staff and improved its effectiveness as a regulator. It remains to be seen how much the CVM will be able to exercise its independence.

## Key issues

*Minority shareholder  
protections are the  
single biggest  
corporate governance  
issue in Brazil*

Control has historically been maintained by restricting ownership of voting equity to family members only. This has led to a significant lop-sidedness between the voting and total capital owned by the controlling shareholder. Today, the vast majority of firms have non-voting shares; on average they represent a predominant part of the trading volume. The high incidence of non-voting shares has threatened to limit the participation of minority shareholders in company decision-making, though increasingly some companies voluntarily grant important rights to minority shareholders.

## Investor protections

*The majority of  
shareholders do not  
have “tag along”  
rights in changes of  
control or going  
private transactions*

The 1997 Privatization Law gave controlling shareholders the right to sell their control block at the highest bid without any obligation for the acquirer to make minority shareholders an offer. If an offer was made, it tended to be disadvantageous. If, on the other hand, investors decided to hold on to their shares they risked that the new owners would drive down the share price after acquiring control. While the legislative changes of 2001/02 re-instituted 80 percent “tag along” rights for all voting shareholders, holders of non-voting stock were still not protected in the case of change of control.<sup>3</sup> This permits companies to exclude non-voting shareholders from important benefits, including during changes of control. A recent example is the March 2004 merger between the Brazilian brewer AMBEV and the Belgian company INTERBREW (which resulted in the world’s largest beer company).<sup>4</sup> Minority voting shareholders received the 80 percent “tag along” stipulated in the law, while the majority non-voting shareholders were entirely excluded from the deal.

*Approval and  
disclosure processes*

The same owner may control listed and private firms and the relationship between the different firms is not transparent to outsiders.<sup>5</sup> It is not always easy

<sup>3</sup> I.e. the tender does not extend to PN shares. Companies listed on *Level II* must give full tag-along rights to all voting shares and pay 70 percent of the control price to non-voting PN shareholders. There are only voting shares in companies listed on the *Novo Mercado* and the tag-along is 100 percent. Black et al (2005), “Corporate Governance Index in Brazil” find that 20 percent of listed firms give tag-along rights to PN shares.

<sup>4</sup> In December, 16, 2004, the CVM’s Board of Commissioners first analyzed the operation involving Ambev and Interbrew, upon request of a pension fund, holder of Ambev preferred shares. This shareholder was appealing to the Board of Commissioners against a previous opinion of the CVM’s technical area affirming that it deemed the operation to be legal and refusing to bring an administrative inquiry to punish controlling shareholders and Board members of Ambev. The Board of Commissioners decision, taken by a majority of its members, maintained the opinion of the technical area and stood for the regularity of the operation. However, it stated that, in theory, the board members of Ambev who were also its controlling shareholders, would be forbidden to intervene in any managerial deliberation concerning the operation due to their potential conflict of interest on its approval. The Board of Commissioners also noticed that the disclosure of the operation was incorrect, incomplete and failed to address material information about the operation. Although this decision did represent neither an obstacle, nor a prohibition to the conclusion of the operation, it gave origin to an ongoing investigative procedure of the technical area aimed at seeking further elements on the two mentioned points.

<sup>5</sup> Mandatory disclosure of direct corporate ownership somewhat helps matters. Subsidiaries, associated and controlled companies need to be disclosed by all firms in their financial statements (Articles 247 to 250 of the Corporate Law, CVM Instruction 247/96 as amended by Instruction 285/98). If a group of companies is specifically constituted under Chapter XXI of the Corporate Law (Article 275) it is subject to consolidation of financial statements and rigorous group-related disclosure.

The CVM has issued Instruction 247/96 (as amended by Instruction 285/98), about the evaluation of investments in controlled and associated companies, and about the procedures of elaboration and disclosure of consolidated financial statements, in order to fully comply with the Fundamental Accounting Principles. As of Instruction 247/86, the CVM required that investments in companies deemed to be equivalent to investments in associated companies should be evaluated by equity method. The Instruction deemed to be equivalent to the associated companies the following situations: a) of the company that holds an indirect stake of at least 10% of another company’s voting

*of related party transactions are not sufficiently regulated in the law*

for minority shareholders to identify “related parties” or to assess the fairness of a transfer price.<sup>6</sup> This provides controlling shareholders with multiple and often perfectly legal opportunities to engage in activities that advance their own interests at the expense of minority shareholders. The approval process is vague – there is e.g. no explicit requirement for the board to approve related party transactions and audit committees are not mandatory.<sup>7</sup>

*Oversight of insider conflicts of interest is insufficient*

Controlling shareholders that are not directors or executives are allowed to vote on most transactions even if there is the possibility that they may be conflicted. Whether or not a certain decision benefited the interested party to the detriment of the company and other shareholders can only be determined ex post, if at all.

*Pension funds and corporate governance funds are beginning to exercise their governance rights*

Pension funds are important institutional investors. Closed pension funds account for 25 percent of the free float.<sup>8</sup> They are starting to play an important monitoring and disciplining role in the governance of corporations. This role is exercised by voting the shares at the AGM or by nominating members to the board of directors or the statutory auditor board (conselho fiscal).<sup>9</sup> Corporate governance funds are committed to promoting good practices and thereby increase the value of their investments.

### Disclosure

*The Corporation Law dealing with reporting requirements, including accounting standards and audit rules, is outdated, but the draft bill creates controversy*

Projeto de Lei 3741, as the financial reporting bill is known, has been before Congress for five years. The most contentious issue, which falls out of the scope of this ROSC, is whether the bill should also apply to the limited liability companies (“Limitadas”), i.e. whether “Limitadas” above a certain size should be obliged to disclose audited financial statements. Another controversy is the treatment of financial leases.

*Brazilian disclosure*

Currently, there is no obligation for issuers to publish cash flow statements or

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capital, but does not control it; b) of the company that holds a direct stake of at least 10% of another company's voting capital, but does not control it. Such dispositions are also applicable in the case a single investment in controlled or associated companies does not reach the cap necessary to suit the definition, but in aggregate with other participations may reach the cap to be compared to an associated company. Instruction 247/96 (Article 11, inc. IV) also sets forth that whenever equity method is used, the investor company must recognize the economic effects resulting from the differences in equity and ownership structure of invested companies.

Instruction 247/96 also states that the company may be waived of including one or more companies from its consolidated financial statements, in special cases and upon previous request to CVM, provided that should this waiver be granted, it would apply only to that fiscal year. Further, Instruction 247/96 also set the rules for elaboration of consolidated financial statements for the cases of joint ventures and shared control, when no shareholder individually holds a controlling position.

Finally, the Instruction 408/04 deals with the inclusion of Special Purposes Entities (SPE) on the corporation's financial statements. By virtue of this Instruction, a corporation is required to consolidate SPE in its financial statements. SPE must be included in explanatory notes whenever the essence of its relationship with the corporation indicates that the activities of such entities are directly or indirectly controlled, individually or jointly, by the corporation. A whole set of investments vehicles would fit the definition of SPE, and, therefore, would be included in the scope of Instruction 408/04, as for instance, exclusive investment funds, asset-backed funds, etc.

<sup>6</sup> The CVM is in the process of assessing its current legal and regulatory framework in this respect, comparison to that adopted in other countries. However, Deliberation CVM nº 26, which was based on IAS nº 24, defines terms of such transactions in a general manner.

<sup>7</sup> In spite of the fact that no mandatory approval is needed for related party transactions, some level of responsibility for their fairness is incorporated in various company organs (the board of directors, the statutory audit board), as well as via standard legal fiduciary duties, such as the duty of loyalty, diligence, and the duty to act in the best interest of the company. Some of the highest fines ever imposed by the CVM were caused by related party transaction cases (in the “Bombril-Cirio” case the controlling owner and some board members were individually fined in the amount of US\$ 25,000,000; the “SAM Industrias case” levied on insiders an even higher fine of US\$ 97,000,000 each).

<sup>8</sup> Source: Latin American Roundtable on Corporate Governance Questionnaire on Enforcement Issues, 2004. Closed pension funds are one of three types of pension funds available in Brazil, and are constituted as employer-sponsored, non-profit organizations covering the employees of a particular firm or group of firms.

<sup>9</sup> See VC.

*requirements are lagging behind international best practices*

provide segment reporting. MD&A and other non-financial disclosures are typically not sophisticated. Local accounting and auditing standards are less detailed than international standards. These issues are discussed in detail in the Accounting and Auditing ROSC conducted by the World Bank in 2005.

*Related party and large transaction disclosure and enforcement are improving but more work is needed*

Brazilian GAAP is less demanding than US GAAP or IFRS in terms of disclosure of related-party transactions. One important step forward was made with the CVM Deliberation 26 on disclosure of related party transactions, which strengthened related-party rules in the spirit of IAS 24. Firms often only report on RPTs in general terms without details except the value of the transaction.<sup>10</sup>

*Mandatory audit firm rotation after five years causes controversy*

The mandatory rotation requirement for auditors was introduced some years ago in the banking sector, but now has become mandatory for all listed companies. There is a lack of consensus among market participants on the effectiveness of this mechanism. While some investors and issuers applaud the measure, many auditors and firms continue to oppose it. The outcomes of the regulation remain to be measured as this year for the first time the rotation is effective in practice.<sup>11</sup>

### **Company oversight and the board**

*Boards continue to play secondary role in governance*

Controlling shareholders exercise significant influence over boards – whether they are on the board directly or control the board through appointees. Most boards consist of family members or their direct representatives (family lawyers and bankers).

*Little guidance on duties of care and loyalty*

Directors owe a duty of loyalty and care to the company, not only to the shareholders who appointed them. However, given that voting shareholdings are so concentrated, it seems that directors often follow the directives of the controlling group.<sup>12</sup>

*No rules on board independence*

Boards have not been opened up to independent directors – the term “independent director” is not defined in the law, nor do any of the three higher BOVESPA listing segments require independent directors.<sup>13</sup> However, there is doubt among market participants whether the concept of an “independent director” accountable to all shareholders, rather than to the shareholders that appointed them, is realistic in the Brazilian environment.

*Audit committees are the exception rather than the rule except in banks*

Audit committees are not mandatory by law and rare in practice, with the exception of banks. The “audit committees” mandatory for banks are not board subcommittees, but they nevertheless assume similar functions. According to Central Bank regulation at least one audit committee member must be a financial expert and must be independent.

<sup>10</sup> The Accounting and Auditing ROSC notes: “A significant minority of the sampled enterprises reported the existence of transactions with related parties. However, none provided information on pricing policies, as required by NBC T 17, Related Parties issued by CFC.”

<sup>11</sup> The Accounting and Auditing ROSC notes: “Based on interviews with regulators, there is anecdotal evidence that supports that the quality of audit increased in some companies after the rotation. It is difficult, however, to attribute such improvements to the rotation alone, as several other measures were taken simultaneously to improve the quality of audit (e.g., independence requirements, CPE, sufficiency exam, etc.). In addition, there was a general trend in the audit industry for stricter adherence to auditing standards in the wake of the corporate scandals in the US and the EU.” [This footnote refers to a paragraph of AA ROSC which the CVM suggested to be altered. Should this change be accepted; the footnote will have to change accordingly.]

<sup>12</sup> In so doing, directors may face liability in following the instructions of the shareholders who appointed them, for any decision that is not in the best interests of the company, or that damages the company (Corporate Law, Article 158).

<sup>13</sup> This might be changing with the upcoming revision of the *Novo Mercado* listing requirements.

*Statutory auditor boards are the only platform for the majority of shareholders to make themselves heard*

In an environment where companies are dominated by controlling shareholders, minorities feel the need to make themselves heard. Traditionally, the one mechanism open to them was the so-called conselho fiscal (“statutory auditor boards”), which is mandatory, as a transitory or permanent body, for listed companies. The law imposes on them wide oversight duties over management and the board, including the supervision of financial reporting. Companies listed on Level II or Novo Mercado should establish full audit committees as part of their board of directors.

### **Enforcement**

*CVM has improved its credibility with the private sector*

CVM has become more effective in overseeing, investigating and enforcing rules and regulations. It also increasingly issues “opinions” with regards to investor issues and market practices. These opinions guide issuers and provide advice to investors with respect to the legality of certain corporate actions.

*Increasing importance of BOVESPA as an enforcing agent*

Companies listed on the special corporate governance segments enter into a contractual relationship with BOVESPA, which sets forth far-reaching corporate governance requirements. The contract also stipulates enforcement powers, including fines.

*Arbitration is yet to be tested*

Companies listed on Level II and Novo Mercado must commit to submit any shareholder dispute to arbitration. The arbitration board renders decisions within six months. While the panel has not been tested, it promises a more efficient and effective enforcement than through judicial procedures.

*Court redress remains a significant obstacle to protecting investor rights*

The court process continues to be slow, with commercial disputes routinely taking several years. The appeal process involves cumbersome procedural rules and takes an additional several years.

*Training and awareness raising activities of the Brazilian Institute of Corporate Governance (IBGC) foster voluntary adoption of good corporate governance*

IBGC has been the most effective corporate governance organization in Latin America and is widely recognized for its contribution to corporate governance reform in Brazil. IBGC works with issuers, investors, directors, management and any other market participant. In the last ten years they have organized an impressive number of meetings, seminars and courses and spread the word that good corporate governance makes good business sense. IBGC has also issued a Code of Best Practices, which has undergone its third revision.

### **Recommendations**

*Mainstream corporate governance*

CVM, BOVESPA, IBGC and firms listed on the Novo Mercado have been major champions and drivers of change. Companies with ADRs also adhere to higher corporate governance standards. The challenge now is to “mainstream” corporate governance reform beyond this limited group of insiders and make it an integral part of the investment climate agenda.

*Pension funds would benefit from appointing more effective and better trained directors to the boards of*

Directors appointed by pension funds usually have a close relationship with the fund or the fund’s sponsor, i.e. they are current or retired employees; and may therefore not be seen as independent. Also, they do not always have the training necessary to assume this responsibility in the best interest of policyholders. Consideration should be given to introducing independence requirements in the medium term, in

<i>portfolio companies</i>	conjunction with such rules in general for listed companies or specific tiers.
<i>State owned companies should be models</i>	Large listed SOEs, such as Petrobras and Banco do Brasil, are traded on the main market. Policymakers should consider changing the bylaws of these firms so that they could migrate to the corporate governance segment Level II. Such action would boost the corporate governance cause and provide listed firms with a model to emulate.
<i>Educate judges on capital markets issues</i>	Judges have no training on financial and capital market issues, which limits their effectiveness to enforce civil and criminal actions in court. CVM may act as amicus curiae and provide advice to the court, if so requested. For the courts to become more efficient in financial market matters, policymakers should consider adding courses on finance and capital markets to the curriculum for judge. Though judicial reform is not the primary focus of this ROSC, it should be noted that a thorough judiciary reform is needed. Civil procedures need to be addressed in view of shortening the appeals process. Further changes are needed at the level of the Superior Courts, promoting modernization and efficiency of the judiciary, and of court structures as a whole. <sup>14</sup>
<i>BNDES, as a long term lender, should play a key role in promoting corporate governance to their borrowers</i>	As the main long term lending institution BNDES should make compliance with certain corporate governance standards a prerequisite for lending (standards of the type used in the Novo Mercado, for example).
<i>Strengthen the approval processes of related party transactions, as well as the continued enforcement of their proper disclosure</i>	<p>Under concentrated and complex ownership structures, the same family may own listed companies and private firms and the relationship between the different parts of the business group may not be transparent to an outsider. Minority investors may not even know the controlling shareholder's position in related companies nor how business between companies of the same group could benefit that shareholder to the detriment of their financial position. Misuse of corporate assets and abuse in RPTs can be perfectly legitimate under the law. Nevertheless, RPTs represent an equitable treatment problem in Latin America. This is why it is imperative that policymakers establish clear, bright line rules on how such transactions should be approved.</p> <p>For example, in Chile a transaction between the company and a director, manager or controller, directly or indirectly, is deemed a related party transaction. This definition includes loans to directors. The related party must disclose his/her interest to the board and the regulator. The board must either approve or reject the transaction with the abstention of the interested director or, if the board is unable to reach a decision, hire two independent evaluators. Their reports are available to the board and shareholders for 20 working days and transmitted to the regulator. Related party transactions must be disclosed at AGMs. When expert opinions differ substantially, or if shareholders with at least five percent of outstanding shares consider the transaction detrimental to them, the transaction must be approved at an EGM by 2/3 of voting shares.</p> <p>Additional recommendations are provided in the annex on page 19-20.</p>

<sup>14</sup> The process of judicial reform has already begun last year, when the government passed an amendment that changed the Federal Constitution (EC 45/2004) in order to enable an ample reform of the court system. As a result of this Amendment, several bills are now in Congress aimed at speeding up civil and criminal actions and developing transparency and efficiency in the courts.

## Summary of Observance of OECD Corporate Governance Principles: Brazil and World Average

Principle	Brazil	Chile	Mexico
<b>I. ENSURING THE BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK</b>			
IA Overall corporate governance framework	75	N/A	N/A
IB Legal framework enforceable and, transparent.	75	N/A	N/A
IC Clear division of regulatory responsibilities.	100	N/A	N/A
ID Regulatory authorities have sufficient authority, integrity and resources.	75	N/A	N/A
<b>II. THE RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS</b>			
IIA Basic shareholder rights	75	75	75
IIB Rights to participate in fundamental decisions.	75	100	50
IIC Shareholders AGM rights	50	75	50
IID Disproportionate control disclosure	50	50	50
IIE Control arrangements should be allowed to function.	75	75	75
IIF The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.	75	75	0
IIG Shareholders should be allowed to consult with each other.	75	N/A	N/A
<b>III. EQUITABLE TREATMENT OF SHAREHOLDERS</b>			
IIIA All shareholders should be treated equally	50	75	50
IIIB Prohibit insider trading	75	50	75
IIIC Board/Mgrs. disclose interests	50	75	50
<b>IV. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE</b>			
IVA Legal rights of stakeholders are to be respected.	100	75	75
IVB Stakeholder redress	100	50	75
IVC Performance-enhancing mechanisms	75	75	75
IVD Stakeholder disclosure	75	100	100
IVE "Whistleblower" protection	75	N/A	N/A
IVF Creditor rights law and enforcement	50	N/A	N/A
<b>V. DISCLOSURE AND TRANSPARENCY</b>			
VA Disclosure standards	50	50	75
VB Accounting standards	50	50	50
VC Independent audit annually	50	50	50
VD External auditors should be accountable to the shareholders	50	N/A	N/A
VE Fair & timely dissemination	100	75	100
VF Research conflicts of interests	50	N/A	N/A
<b>VI. RESPONSIBILITIES OF THE BOARD</b>			
VIA Acts with due diligence, care	50	50	50
VIB Treat all shareholders fairly	50	50	50
VIC High ethical standards	75	75	75
VID The board should fulfill certain key functions	50	75	50
VIE The board should be able to exercise objective judgment	25	50	50
VIF Access to information	75	75	100

Source: All Completed ROSCs FY02-FY04

Note: The numerical ratings correspond to: 100=Observed; 75=Largely Observed; 50=Partially Observed; 25=Materially Not Observed; 0=Not Observed.



## Principle - By - Principle Review of Corporate Governance

This section assesses Brazil's compliance with each of the OECD Principles of Corporate Governance. Policy recommendations may be offered if a Principle is less than fully observed. **Observed** means that all essential criteria are met without significant deficiencies. **Largely observed** means only minor shortcomings are observed, which do not raise questions about the authorities' ability and intent to achieve full observance in the short term. **Partially observed** means that while the legal and regulatory framework complies with the Principle, practices and enforcement diverge. **Materially not observed** means that, despite progress, shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. **Not observed** means no substantive progress toward observance has been achieved.

### SECTION I: ENSURING THE BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

**Principle IA:** The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.

**Assessment:** Largely observed

**Capital markets.** As of December 31, 2004, BOVESPA's market capitalization was US\$ 330.3 billion, or 48 percent of 2003 GDP, and the turnover ratio was 35 percent.<sup>15</sup> Some 391 companies were listed on the exchange, including 27 SOEs. The top ten securities represented 45 percent of trading value and the top twenty 70 percent. Most trading was in non-voting shares. 74 companies have ADRs.<sup>16</sup> 29 companies went private in 2004, mainly due to mergers and consolidations. There were 13 public offerings, of which seven were IPOs. The net effect of market entry and exit was an increase in the market value of the free float in the amount of R\$6,475 (US\$2,355) million.<sup>17</sup>

Country Name	Market Cap % GDP 2004	Market Cap (current \$US mill) 2004	Stocks traded, turnover ratio (%), 2004	Listed Comp. 2004
Argentina	32.1	46432	17.8	104
Brazil	70.3	330347	34.8	357
Chile	130.2	117065	12.1	239
China	40.2	639765	113.3	1384
India	58.5	387851	115.5	4730
Mexico	19.6	171940	29.4	152

Source: World Bank WDI Indicators online (May 2005), Country stock exchange websites

**Ownership framework.** Foreign ownership is about 25-29 percent, followed by institutional ownership of 9 percent and government ownership of 8 percent. The ownership structure of listed firms is highly concentrated. BOVESPA estimates the free float to be approximately 35 percent (mainly non-voting PN shares). Foreign ownership restrictions persist in certain industries, including air transportation, cable, TV and media.<sup>18</sup>

**Institutional Investors.** There are three types of private pension fund schemes in Brazil: (1) closed pension funds,<sup>19</sup> (2) open pension funds and (3) individual retirement funds.<sup>20</sup> Closed funds comprise the largest category with US\$104.2 (16 percent of GDP) in assets as of December 2004.<sup>21</sup> Open funds had approximately US\$15.8 billion of assets under

<sup>15</sup> Source: World Bank Central Database.

<sup>16</sup> Source: CVM data collection from custodians.

<sup>17</sup> Market value of new listings R\$ 7,535 millions as compared to R\$ 1,080 of delisting (as of February 14, 2005). Source: BOVESPA.

<sup>18</sup> Foreign ownership is not allowed at all in valuables transports, lottery services, medical assistance, nuclear mineral-related activities, and oil prospecting and refining. For the sectors mineral exploration, agriculture, forestry and maritime, river and lake transport and insurance, it is necessary to obtain authorization from the competent authorities.

<sup>19</sup> In November 2004, there were 366 closed pension funds, 83 of which sponsored by the public sector. Previ (Banco de Brasil), Petros (Petrobras), Funcef (Caixa Economica), Sistel (Telemar), Valia (CVRD), Centrus (Central Bank), Itaubanco (Itau), Forluz (Cemig), Real Grandeza (Furnas) and Fapes (BNDES) are the largest ones. Source: Petros, "Relatório de atividades", December 2004.

<sup>20</sup> Closed funds are regulated by the *Secretaria da Previdência Complementar* (SPC), while open/individual retirement funds are supervised by the *Superintendência de Seguros Privados* (SUSEP).

<sup>21</sup> Source: Petros, "Relatório de atividades", December 2004.

management (3 percent of GDP), with negligible equity holdings.<sup>22</sup> Resolution 3121<sup>23</sup> increases the equity investment ceiling of 35 percent to 45 percent for companies listed on *Level I* and 50 percent for companies listed on *Level II* or the *Novo Mercado*. Given that only 27 percent of closed pension fund assets are equity holdings,<sup>24</sup> the resolution does not at present represent an incentive to re-allocate equity investments to better-governed companies. Large public sector pension funds participated in the privatizations of the 1990s. In such cases they are parties to shareholder agreements that give them the right to a seat on the board of directors. As minority investors, their influence is substantial as well.

**Corporate Governance Funds.** Local asset managers had US\$204.6 billion under management in 2004,<sup>25</sup> only 6 percent of which were equity investments. The four principal funds that focus on corporate governance in Brazil are *Bradesco Templeton de Valor e Liquidez*, *Dynamo*, *Fator Sinergia* and *Investidor Profissional*.<sup>26</sup> These funds are committed to promoting good practice in corporate governance in an effort to improve the profitability of their investments. Other funds are also starting to require their portfolio companies to adhere to certain corporate governance standards. The Private Equity Investment Funds (Fundos de Investimento em Participação) organized under Instruction 391/02 are allowed to invest in closed and publicly held companies, as long as they effectively participate in the decision process of their investees, with concrete influence on their strategic policy and management, notably by appointing Board Members.<sup>27</sup>

**Principle IB. The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.**

**Assessment: Largely observed**

**Corporate legal framework.** Brazil is a civil law country. The legal framework governing companies is Law 6,404/1976, as amended (the "Corporation Law"). Law 10,303/2001 and Law 10,411/2002 reforming both the Corporation and Securities Laws passed the Senate in the fall of 2001. However, significant legal gaps remain, especially with respect to financial reporting and minority shareholder protections.

**Company types.** The most widely adopted form of corporate organization is the *sociedade limitada*,<sup>28</sup> similar to the limited liability company. There is no cap on the maximum share capital or number of shareholders for *limitadas*. According to estimates, the *limitadas* represent 90-95 percent of all firms. The *sociedade anônima* can be private or public. Only public SAs can issue securities on the market.

**Securities law framework.** A public SA must be registered with the securities regulator. Law 6,385/1976, as amended (the "Securities Law") and a number of CVM instructions govern public companies.

**Listing rules.** Listed firms are governed by the *Regulamento de Listagem*, the listing rules of BOVESPA. In addition to the main board, BOVESPA introduced differentiated market segments for issuers who voluntarily abide by higher corporate governance practices than those prescribed by law.<sup>29</sup> *Nível I* rules focus mainly on improved disclosure, including disclosure of shareholder agreements and more quarterly information. *Nível II* adds a broader range of corporate governance practices and minority shareholder rights, such as a single year mandate for the board of directors, adherence to arbitration, the granting of voting rights to non-voting "PN" shareholders for certain fundamental decisions, and 70 percent "tag along" rights for "PN" shares. Firms listed on the *Novo Mercado* must adopt the one-share-one vote principle. As of February 2005, there were 9 companies listed on the *Novo Mercado*,<sup>30</sup> 8 on *Nível II* and 34 on *Nível I*. While the majority of firms continue to be listed on the main board, there is relatively less trading on that level as investor interest is concentrated at the higher levels. BOVESPA is in the process of creating a new market segment to attract smaller firms – the corporate governance requirements are expected to be similar to those of the *Novo Mercado*, but there will be e.g. no free float requirement, the minimum number of directors will be 3 (rather than 5) and US GAAP/IFRS will not be mandatory. The goal of the new segment is to increase liquidity over time and provide analyst coverage for smaller firms.

**Codes.** The *Instituto Brasileiro de Governança Corporativa* (IBGC) issued the "IBGC Code of Best Practices" in 1999. The third revision of the Code was finalized in 2004. In 2002, CVM issued the "CVM Recommendations on Corporate Governance". While public companies should include their level of compliance ('comply or explain') in the IAN, this is not enforced in practice. Surveys on corporate governance of listed firms have been conducted by R. Leal and Black/Carvalho.

**Principle IC. The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.**

<sup>22</sup> Source: SUSEP.

<sup>23</sup> Issued by the National Monetary Commission (CMN).

<sup>24</sup> Excluding Previ, which has 59 percent of assets invested in equities, the equity holdings drop to 14.6 percent of assets.

<sup>25</sup> This amount includes a significant portion of the R\$240 (US\$88.9) billion outsourced by Pension Funds (Source: Latin America Roundtable on Corporate Governance Questionnaire on Enforcement Issues, 2004).

<sup>26</sup> These are known as "PIPES", i.e. private investment in public equity.

<sup>27</sup> During the first semester of 2005, public offerings of private equity investment funds represented US\$ 550 million.

<sup>28</sup> Governed by articles 1052-1087 of the Civil Code (Law 10,406, of January 10, 2002).

<sup>29</sup> For full listing requirements, please refer to [http://www.novomercadobovespa.com.br/english/nm\\_reg1122001i.pdf](http://www.novomercadobovespa.com.br/english/nm_reg1122001i.pdf) and [http://www.bovespa.com.br/pdf/ndif\\_reg07112001i.pdf](http://www.bovespa.com.br/pdf/ndif_reg07112001i.pdf). The listing rules will be revised in 2005.

<sup>30</sup> CCR (Companhia de Concessões Rodoviárias), CPFL Energia S.A., Diagnosticos Da America S.A. (DASA), Grendene S.A., Natura Cosméticos S.A. (Natura), Porto Seguro S.A., and Cia Saneamento Basico Est Sao Paulo (SABESP).

**Assessment: Observed**

**Securities regulator.** CVM is the securities regulator.<sup>31</sup> It supervises the stock exchange, the futures and commodities exchange, the clearing systems, investment funds, as well as public companies. Together with the Central Bank, it licenses and regulates securities brokers and dealers. In 2004, there were 470 staff and the budget was 25.8 million dollars.<sup>32</sup> CVM has "secondary legislation" powers; every rule is subject to a public consultation process. The 2001 legal reforms elevated CVM to the level of independence of other regulatory agencies with fixed managers. This has made it possible for CVM to hire professional staff and improved its effectiveness as a regulator. It remains to be seen how much the CVM will be able to exercise its independence. The board consists of a chairman and four directors nominated by the President of Brazil and approved by the Senate for a five years' term. They can only be removed for cause. CVM is accountable to the Ministry of Finance.

**Stock exchange.** BOVESPA operates as non-profit SRO under the supervision of CVM.<sup>33</sup> The board is composed of ten members, six of whom represent member firms, including the chairman. BOVESPA has a surveillance unit with 21 people in charge of monitoring compliance with the listing rules. Under the contractual commitments with firms listed on the corporate governance segments, BOVESPA has fining powers. SOMA is the over-the-counter market. It was acquired by BOVESPA in 2002 and is now a segment market of BOVESPA.

**Central depository.** The Brazilian Clearing and Depository Corporation (CBLC) is the central depository for equities.<sup>34</sup> It is owned by banks, brokers and the stock exchange. CBLC does not have registrar functions. These are offered by banks.

**Banking regulator.** The Central Bank of Brazil is the banking supervisor. The responsibility to define the financial reporting requirements lies with the Central Bank, whose regulatory objectives are of a prudential nature and also, as of the securities regulator, information-based. Furthermore, the Central Bank of Brazil has undertaken significant steps in promoting a good CG environment. Specifically, Resolution 2.554 requires the establishment of an internal control system in banks, to monitor all the inherent risks to which banks are exposed. Resolution 3.040 of 2002 sets rules for entry of new institutions into the financial system, including extensive disclosure rules on controlling parties and corporate governance standards (e.g. incentive contracts and remuneration schemes) that the institution will observe. Resolution 3.041, amended by Resolution 3.141, sets out fit and proper requirements for senior management. Finally, Resolution 3.198 regulates external auditors, including independence and the audit committee requirements.

**Company Registrar.** The *Junta Commercial* registers companies and maintains their founding documents, as well as AGM minutes. It reports jurisdictionally to the Ministry of Justice, and technically to the Federal Department of the Mercantile Registry. There are 27 state registrars. They have no monitoring or enforcement powers over the compliance with filings or the quality of information.

**Other. National Development Bank.** BNDES,<sup>35</sup> the state owned development bank, is one of the only sources of long-term finance.<sup>36</sup> In 2001, BNDES created the program *apoio as novas SAs* that applied the rules of the *Novo Mercado* to non-listed SMEs and participated in corporate governance investment funds.<sup>37</sup> In 2002, BNDES started a program that promoted corporate governance by rewarding well governed firms with e.g. a reduction of spreads. A re-launching of this program or a similar promotion program focusing on disclosure, is under discussion at the moment.

**Court.** Lawsuits involving a violation of shareholders rights are heard by state court judges and can be appealed to the Supreme Court.<sup>38</sup> With the exception of the commercial court in Rio, there are no special courts and jurisprudence is poor because of the scarcity of judicial precedents and because judges are not trained in securities issues. The courts are slow, with commercial litigation lasting up to 6 years in Sao Paulo, and 3 years in Rio. Appeal processes involve cumbersome procedural rules<sup>39</sup> and take several years; the aggrieved party may incur substantial costs.<sup>40</sup> Companies may stipulate in their bylaws that disputes between the company and its shareholders or between controlling and minority shareholders be submitted to arbitration.<sup>41</sup> Once the parties agree to arbitration, the rulings are final and irrevocable. Companies listed on *Nivel II* or the *Novo Mercado* must undertake to adhere to arbitration as the vehicle to resolve corporate disputes.<sup>42</sup>

<sup>31</sup> *Comissão de Valores Mobiliários.*

<sup>32</sup> Latin American Roundtable on Corporate Governance Questionnaire on Enforcement Issues, 2004

<sup>33</sup> Article 8 and 17 of the Securities Law; National Monetary Council Resolution 2,690 of January 28, 2000.

<sup>34</sup> CETIP is the depository for bonds.

<sup>35</sup> *Banco Nacional de Desenvolvimento Econômico e Social.*

<sup>36</sup> With financing operations in the amount of US\$ 16 billion in 2004.

<sup>37</sup> *Programa de fundos de liquidez e governança.*

<sup>38</sup> With the exception of cases involving federal public entities where the federal courts have competence.

<sup>39</sup> Including the right to interlocutory appeal, i.e. the right to appeal decisions before a case is completed.

<sup>40</sup> Court costs vary from state to state. In São Paulo, for example, the plaintiff pays state distribution fees at one percent of the case value, up to 1,500 *salários mínimos* (minimum wage) and 0.5 percent on the amount in excess of such limit.

<sup>41</sup> Article 109 of Corporation Law.

<sup>42</sup> The arbitration board must give decisions within six months. The board consists of 33 arbiters, which include former CVM presidents, lawyers, representatives from the broker industry, etc. Out of that list, both defendant and plaintiff choose each one arbiter, and agree on a third arbiter (should they fail to agree, the president of the arbitration board chooses the third one).

According to interviews with issuers, companies still find arbitration an unfamiliar concept, and are wary of it, waiting to see if it will function in practice. Some mention it as a major obstacle to joining *Nivel II* or the *Novo Mercado*.

**IBGC.** The Corporate Governance Institute was founded in 1995 as the first private sector entity devoted to corporate governance in Latin America. Today it is recognized widely for its contribution to corporate governance reform. IBGC organizes an impressive number of meetings, seminars and courses for directors and other market participants. In 2004, approximately 1000 people were trained by IBGC. IBGC also provides advisory services on corporate governance.

**ANIMEC.** The investor association has had some success defending the interests of minority shareholders in corporate transactions, which were considered detrimental to minority shareholders, especially to “PN” shareholders.

**Principle ID. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfill their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.**

**Assessment: Largely observed**

**Authority, integrity and resources of regulators.** CVM's budget is US\$25.8 million, and it has 470 employees. CVM has wide enforcement powers. It can initiate administrative proceedings.<sup>43</sup> CVM's decisions can be appealed to the *Conselho de Recursos do Sistema Financeiro Nacional* (CRSFN) and be challenged in court.<sup>44</sup> The board of CVM can impose penalties.<sup>45</sup> Criminal offenses are referred to the Public Prosecutor.

## SECTION II: THE RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS

**The corporate governance framework should protect and facilitate the exercise of shareholders' rights.**

**Principle IIA: The corporate governance framework should protect shareholders' rights. Basic shareholder rights include the right to:**

**Assessment: Largely Observed**

(1) Secure methods of ownership registration	Evidence of ownership is registration in the corporate share register, which is kept by the company or outsourced to a registry operated by a bank. About 90 percent of listed companies keep their shares at private share registries. <sup>46</sup> The Brazilian Clearing and Depository Organization CBLC maintain separate accounts for each beneficiary in the name of the ultimate owner. Shares are dematerialized. There are no bearer shares. The concept of nominee ownership does not exist.
(2) Convey or transfer shares	Public firms have no restrictions or veto rights limiting share transferability. Shareholder agreements may include transfer restrictions. DVP is final and irrevocable on T+3. <sup>47</sup>
(3) Obtain relevant and material company information on a timely and regular basis	Annual and quarterly reports are available at CVM, BOVESPA, published in the press, as well as on company websites. Copies of by-laws, ownership, outstanding debt, dividends, treasury shares and other corporate information are available from CVM free of charge. Minutes of shareholder meetings may be obtained at the Company Registrar and also on the CVM's website, free of charge.
(4) Participate and vote in general shareholder meetings	Shareholders of ordinary voting shares (“ON” shares) attend and vote at shareholder meetings. Shareholders of non-voting shares (“PN” shares without voting rights) may attend, speak, but not vote, <sup>48</sup> unless the issue is related to the rights of their class of shares. <sup>49</sup>

<sup>43</sup> CVM has access to all company information, except for phone records. CVM does not have access to information protected by the bank secrecy law without court permission. CVM can act as expert witness in criminal trials

<sup>44</sup> National Financial System Appeal Council. It serves as the appeal instance for administrative sanctions.

<sup>45</sup> Article 11 of the Securities Law. Penalties include warnings, fines up to 50 percent of the value of the transaction or three times the amount of the gain or loss avoided, suspension of trading or of directors/statutory auditor board members or disqualification for the position (up to 20 years); temporary or permanent prohibition to carry out certain activities, prohibition to act in certain kinds of market transactions, annulment of authorizations or registrations. The consent decree allows CVM to settle administrative proceedings. It may involve a wide variety of compensation alternatives, including the donation of funds to charity and the compensation of expenses incurred by CVM.

<sup>46</sup> Mainly Banco Itau, Bradesco, and Unibanco.

<sup>47</sup> Guaranteed by law 10.214/2001.

<sup>48</sup> According to Article 111 of Corporate Law, preferred shares may acquire voting rights if the dividends of these shares are not distributed within the term set forth in the company's by-laws, which may not be larger than 3 years.

<sup>49</sup> Companies listed on *Nivel II* must grant “PN” shareholders voting rights under special circumstances, e.g. (i) mergers, consolidations or spin-offs; (ii) related party transactions; (iii) valuation of in-kind contributions in capital increases; (iv) firm selection to determine “economic value”; (v) changes in bylaws.

(5) Elect and remove board members	<p><b>Process.</b> “ON” shareholders are entitled to elect and remove directors</p> <p><b>Cumulative voting/proportional representation.</b> Shareholders representing 10 percent of capital may request cumulative voting. Shareholders representing 15 percent of voting capital have the right to appoint one board member. Starting in 2006, PN shareholders can elect one director, provided they hold at least 10% of the share capital.<sup>50</sup> If neither of these thresholds is reached, the two groups may jointly nominate one director with 10 percent of share capital.</p>
(6) Share in profits of the corporation	<p>The annual general meeting (AGM) approves the distribution of dividends.<sup>51</sup> The minimum mandatory dividend is 25 percent or, if the bylaws are silent, 50 percent.<sup>52</sup> Approval of 50 percent of voting capital is required to reduce the mandatory dividend and provided that the 25 percent minimum is maintained. In any case, dissenting shareholders have withdrawal rights if the deliberation is approved.<sup>53</sup></p>
<p><b>Principle IIB. Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as:</b></p>	
<p><b>Assessment: Largely observed</b></p>	
(1) Amendments to statutes, or articles of incorporation or similar governing company documents	<p>Fundamental corporate decisions, including the amendment of bylaws, are taken at extraordinary shareholder meetings. The quorum is two-thirds of voting capital for the first call. There is no quorum for the second call. Simple majority takes decisions, except for the (i) creation of non-voting shares or increase in an existing class of non-voting shares that changes the ratio to the remaining class of non-voting shares; (ii) changes in the rights of non-voting shares or creation of a more favored class; (iii) reduction of mandatory dividends; (iv) mergers; (v) incorporation into a business group; (vi) changes in corporate purpose; (vii) liquidation; (viii) creation of participation certificates; (ix) spin-offs; (x) dissolution; where approval of 50 percent of voting capital is required.<sup>54</sup></p>
(2) Authorization of additional shares	<p><b>Issuing share capital.</b> Authorized capital is defined in the bylaws or determined by shareholders; share issuance up to such limit may be delegated to the board.<sup>55</sup> There is no time cap for boards to issue capital up to this limit.</p> <p><b>Pre-emptive rights.</b> Shareholders have pre-emptive rights, which may be waived by them on a case by case basis.<sup>56</sup> They do not have to be honored if the securities are placed (i) through the stock exchange or public subscription or (ii) through a shares exchange in a public offer to acquire control.<sup>57</sup></p>
(3) Extraordinary transactions, including sales of major corporate assets	<p><b>Sales of major corporate assets.</b> Mergers, consolidations, integrations into business groups, spin-offs and liquidations require the approval of at least 50 percent of voting shares.</p>
<p><b>Principle IIC: Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:</b></p>	
<p><b>Assessment: Partially observed</b></p>	
(1) Sufficient and timely information on date, location, agenda, and issues to be decided at the general	<p><b>Meeting deadline.</b> The board calls the AGM within four months of the end of the fiscal year. If not, the <i>conselho fiscal</i> may do so, as well as any shareholder, should the board fail to do so for more than 60 days.<sup>58</sup> Additionally, shareholders representing 5 percent of capital may call a meeting whenever the board does not attend to their request, within 8 days.<sup>59</sup> If the matter to be discussed is the establishment of a <i>conselho fiscal</i>,</p>

<sup>50</sup> Article 141 of Corporation Law.

<sup>51</sup> Article 132 of Corporation Law.

<sup>52</sup> Article 202 of Corporation Law 10.303/01.

<sup>53</sup> Articles 136 and 137 of Corporation Law.

<sup>54</sup> Article 121-136 of Corporation Law

<sup>55</sup> Article 168 of Corporation Law

<sup>56</sup> Article 109 of Corporation Law

<sup>57</sup> Article 172 of Corporation Law

<sup>58</sup> Article 123, sole paragraph, “b”

<sup>59</sup> Article 123, sole paragraph, “c”

meeting	<p>shareholders representing 5 percent of non voting “PN” shares may call a meeting.<sup>60</sup></p> <p><b>Meeting notice.</b> The regular notice period is fifteen days.<sup>61</sup> The notice is published in the official gazette (<i>Diário Oficial</i>) and in a newspaper. CVM has the power to lengthen the advance notice to thirty days, if the meeting is to deal with complex issues, or to interrupt the notice, if the meeting is to deal with issues that violate any law or regulation.</p> <p><b>Information available.</b> The notice, published three times, contains the date, time, place, agenda, and exact wording of amendment to bylaws, if any are proposed.<sup>62</sup> If a company includes “general matters” on the AGM, the registrar will object.</p> <p><b>Quorum rules.</b> The quorum is one quarter of voting capital for the first call; there is no quorum for the second call. Simple majority takes decisions. AGM minority shareholder attendance is low, with some foreign and domestic funds represented by their lawyers. Since 2001, when CVM was given the power to interrupt the notice period of a general meeting whenever it deems that the matter to be discussed is illegal, there were 18 interruption requests. Of these, the CVM did interrupt 3 general meetings, one of which was authorized later on, after the CVM reviewed its preliminary ruling on the legality of the transaction.</p>
(2) Opportunity to ask the board questions at the general meeting	<p><b>Forcing items onto the agenda.</b> Shareholders cannot put forward resolutions, except for the establishment of a <i>conselho fiscal</i> (see VC), which can be approved by the AGM, even if this is not an item on the agenda. Otherwise, items not on the agenda cannot be voted on at the GM.</p> <p><b>Questions.</b> Shareholders may ask questions.<sup>63</sup> At the request of shareholders with 5 percent of capital, directors must disclose matters relevant to the firm’s activities.<sup>64</sup></p>
(3) Effective shareholder participation in key governance decisions including board and key executive remuneration policy	<p>The GM approves the total package of director and executive remuneration, which the board then allocates among members and executives. There is no detailed information on newly nominated board members available to the AGM.<sup>65</sup></p>
(4) Ability to vote both in person or in absentia	<p><b>Proxy regulations.</b> Shareholders, company officers, lawyers or a financial institution can act as a proxy. Notarization is necessary. In the case of foreign investors, the notary seal must be legalized at a Brazilian consulate, translated into Portuguese by a certified public translator and registered with the Registry of Deeds and Documents.<sup>66</sup></p> <p><b>Postal and electronic voting.</b> Postal or electronic voting is not permitted.</p>
<p><b>Principle IID: Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.</b></p>	
<p><b>Assessment: Partially observed</b></p>	
<p><b>Classes of shares.</b> There are two classes of shares: voting “ON” shares and non-voting “PN” shares. Unlike preferred shares in other jurisdictions, the law did not originally grant “PN” shares economic rights to convert them into quasi debt instruments.<sup>67</sup> “PN” non-voting shares are comparable to non-voting, perpetual, common equity. A non-financial company was permitted to have up to two-thirds of its equity stock in “PN” shares, which means that a company could be controlled with 16.7 percent of total share capital (25.1 percent for new companies).<sup>68</sup> Non-voting “PN” shares represent a little more than 50 percent of the total number of shares and about 90 percent of the trading volume.<sup>69</sup></p> <p>Brazilian firms also use pyramids and shareholder agreement to concentrate corporate control. Cross-shareholdings are not</p>	

<sup>60</sup> Article 123 of Corporation Law

<sup>61</sup> Eight days’ in advance notice for the second call

<sup>62</sup> Article 124 of Corporation Law

<sup>63</sup> Article 134, paragraph 1 of Corporation Law

<sup>64</sup> Article 157 & 158 of Corporation Law

<sup>65</sup> Article 152 of Corporation Law. See also Principle VID (5).

<sup>66</sup> The power of attorney has to be approved every year

<sup>67</sup> In an effort to clarify the privileges of “PN” shares, article 17 (paragraph 1) of Law 10,303 (2001) established that companies may choose among three options: (i) priority in dividends corresponding to at least 3 percent of the net equity value per PN share; (ii) “tag along” rights at 80 percent of the price paid to the controlling shareholder in a change of control or (iii) dividends at least 10 percent higher than the dividend paid to common “ON” shares.

<sup>68</sup> Law number 10,303 restricts the percentage of “PN” shares to 50 percent for new companies or IPOs, but existing listed companies may comply with the 67 percent cap even in share issues.

<sup>69</sup> Ricardo Leal and André Carvalhal-da-Silva: “Corporate Governance and Value in Brazil (and in Chile)”, 2004

frequent, and voting caps are not used. Some privatized companies have golden shares.

**Ownership disclosure by companies.** While shareholders have the right to request an updated shareholder list from the company at any time, in practice this is not always easy. Companies must disclose shareholders owning directly or indirectly 5 percent of capital or more in the IAN. Such information is available up to the beneficial owner, be it a non-listed company, an individual, or an offshore company. The purchase or sale of 5 percent of voting capital is published by the investor relations officer in a newspaper and disclosed on the company website.<sup>70</sup> Firms or their controlling shareholders may request CVM not to disclose ownership information if it is deemed to put at risk the legitimate interests of the company.<sup>71</sup>

**Ownership disclosure by shareholders.** Upon purchase or sale of 5 percent of shares, shareholders must notify CVM and BOVESPA immediately. Thereafter, any 5 percent increase or decrease must be notified.<sup>72</sup> Disclosure must include name and identification, purpose of the transaction, number of shares held and existence of any voting agreement. Under instruction 358, CVM may waive this requirement, which it routinely does if the acquisition of the 5 percent did not intend to change the composition of control or the administrative structure of the company, and also considering the dispersion of the company's free float. .

**Disclosure of shareholder agreements.** Shareholder agreements must be deposited with the company to be enforceable against the company and third parties. Listed companies must disclose shareholder agreements which are deposited with the company. Shareholder agreements affecting (i) share price; (ii) investment decision; (iii) the investor's decision to exercise corporate governance rights, must be reported as material events and published in the newspaper and on the company website.<sup>73</sup>

#### Principle IIE: Markets for corporate control should be allowed to function in an efficient and transparent manner.

##### Assessment: Largely observed

(1) Transparent and fair rules and procedures governing acquisition of corporate control

**Basic description of market for corporate control.** CVM instructions 358 and 361/02 articulate the rules for the market for corporate control. They set out how shareholders will be treated, demand full disclosure by all parties and provide shareholders with reasonable time to decide whether to tender. The board explains the reasons for the merger, but does not issue an opinion on the fairness of the transaction nor recommend a course of action.<sup>74</sup> Both AGMs approve. Given the strong concentration of control and low liquidity of voting shares, there are few hostile takeovers.

**Tender rules/mandatory bid rules.** Acquisition of enough shares to transfer control<sup>75</sup> triggers a public offer to minority "ON" shareholders at 80 percent of the control price.<sup>76</sup> Non-voting "PN" shareholders do not have "tag along" rights, except if their firm is listed on *Nivel II* (70 percent of control premium) or on the *Novo Mercado* (full tag along rights).

Some companies avoid tender offer rules by engaging in a "merger of shares"<sup>77</sup> transaction, through which the buyer acquires all shares and then transforms the acquired company into a wholly owned subsidiary.<sup>78</sup> The only protection available to minority shareholders in this case are withdrawal rights – and those are exercisable at book value, unless the bylaws stipulate otherwise. This technique was used e.g. when ABN Amro bought Sudameris and minority shareholders did not accept the tender offer to go private.

**Delisting/going private procedures.** A public tender offer has to be made, whenever the controlling shareholder acquires more than 1/3 of each class of outstanding shares or CVM determines that there is a "suppression of liquidity". Law 10,303/2001 and CVM ruling 361/2002 establish that the tender offer for the entire free float must be priced at "fair value". "Fair value" is determined by expert appraisal. An offer is successful if more than two-thirds accept the offer. Dissenting shareholders have three months during which to sell their shares at the auction price. Minority shareholders with 10 percent of the free float may request a reassessment<sup>79</sup> or refuse to de-list by not accepting the offer. In this case,

<sup>70</sup> CVM Instruction 358, Article 12.

<sup>71</sup> CVM Instruction 358, articles 6-7.

<sup>72</sup> CVM Instruction 358, Article 12.

<sup>73</sup> Article 118 of Corporation Law and CVM Instruction 35, Article 2.

<sup>74</sup> Article 225 of Corporation Law

<sup>75</sup> "Transfer of control" is straightforward in companies with one controller, but somewhat more complex in the case of control blocks, when some shareholders sell, while others may not.

<sup>76</sup> Article 254A. of Corporation Law. Shareholders have the option to keep their holdings in exchange for the control premium minus market value. Minority "ON" shareholders of companies listed on *Nivel II* have full "tag along" rights.

<sup>77</sup> *Incorporação de Ações*

<sup>78</sup> This transaction is not addressed in rule 361; it is governed by the Corporation Law

<sup>79</sup> If according to the new appraisal the price is lower or equal to the price offered by the controller, the dissenting shareholders must reimburse the company for any costs incurred.

	<p>the person offering is prohibited from launching a new offer for one year.</p> <p><b>Squeeze out provisions.</b> If ownership concentration exceeds 95 percent, the company may squeeze out the remaining shareholders by purchasing their shares at the offer price.</p> <p><b>Abuse to buy-backs/treasury shares.</b> A company or its subsidiary may acquire its shares to cancel them or keep them in treasury, if the bylaws allow it. CVM instructions 358/369 define the acquisition of treasury stock as a material event. Share repurchases must be offered on equal terms to all shareholders.</p>
(2) Anti-take-over devices	<p>Anti-takeover devices are rare due to the concentrated ownership structure and control concentration made possible by “PN” shares. However, provisions alerting to potential control acquisition activity are appearing among firms listed on the <i>Novo Mercado</i>, e.g. a mandatory tender by holders of 8 percent or more of shares, provided for in the company bylaws. Share buy-backs cannot be conducted before a merger.</p>
<p><b>Principle IIF: The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.</b></p>	
<p><b>Assessment: Largely observed</b></p>	
(1) Disclosure of corporate governance and voting policies by institutional investors	<p><b>General obligations to vote/disclosure of voting policy.</b> There are rules in place to require the disclosure of voting policy by pension funds and asset managers.</p> <p><b>Special rules for institutional investors/pension funds.</b> Resolution CGPC 1/01 requires that closed pension funds disclose quarterly what shareholder meetings they attended and how they voted. This information should be available on the websites of the pension funds, but compliance is not monitored closely by SPC. Resolution CGPC 13 obliges closed pension funds to have a clear corporate governance policy and recommends they adopt corporate governance and ethics manuals/codes.</p> <p>CVM instruction 377/02 requires mutual funds to specify in the Offering Memorandum what policy they will adopt with respect to share voting. If the fund votes, asset managers must inform semi-annually how they voted in the meetings they attended.</p> <p><b>Blocked shares/record date.</b> The Corporation Law does not specify a record date for voting at the AGM, but shares are not blocked from trading prior to the AGM.</p>
(2) Disclosure of management of material conflicts of interest by institutional investors	<p>The large pension funds are adopting corporate governance codes to organize their internal governance.<sup>80</sup> The board of <i>PETROS</i>, for example, consists of six members – three appointed by the sponsor (Petrobras) and three elected. The chairman is chosen among the directors appointed by the sponsor. In private funds, the proportion is two thirds sponsors, one third participants. This governance structure is disclosed to the public.</p> <p>It is common for retired and current employees, including asset managers of strategic investments, to represent pension funds on the boards of portfolio companies. This is not considered to constitute a conflict of interest.</p>
<p><b>Principle IIG: Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.</b></p>	
<p><b>Assessment: Largely observed</b></p>	
<p><b>Rules on shareholder cooperation in board nomination/election.</b> There are no rules. It is customary for pension funds to elect directors to the boards of portfolio companies either individually or jointly.</p> <p><b>Rules on communication among minority shareholders.</b> There are no special rules. Nevertheless, cases of shareholder communication and mobilization have occurred in certain important corporate events, as for instance going-private transactions (Sudameris, Latasa and Cremer cases), voluntary tender offers (Bardella and Rodhia-Ster voluntary offers), etc. The practical difficulties of obtaining a full shareholder list may obstruct communication among minority shareholders, especially in view of the new rules of director election by minority PN shareholders.</p> <p><b>Proxy solicitation or other formalities required.</b> The usual proxy rules apply (see IIC).</p> <p><b>Rules on communication among institutional investors.</b> There are no special rules. There is little communication except when it comes to jointly nominate a board member.</p>	

<sup>80</sup> Previ, Petros and Funcef

## SECTION III: THE EQUITABLE TREATMENT OF SHAREHOLDERS

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

Principle IIIA: All shareholders of the same series of a class should be treated equally.

Assessment: Partially observed

<p>(1) Equality, fairness, and disclosure of rights within and between share classes</p>	<p><b>Availability of share class information.</b> The rights attached to each class of shares are described in the bylaws and available from CVM, BOVESPA and the company.</p> <p><b>Equal rights within classes.</b> Corporation Law requires equal treatment of shareholder of the same class (Article 109, §1<sup>st</sup>). However, the absence of full “tag along” rights for all shareholders of the same class constitutes a violation of the equitable treatment principle.</p> <p><b>Approval by the negatively impacted classes of changes in the voting rights.</b> Changes in “PN” rights call for approval from “PN” shareholders.<sup>81</sup> If the PN meeting fails to ratify the changes within 1 year, the changes are void.</p>
<p>(2) Minority protection from controlling shareholder abuse; minority redress</p>	<p>Shareholders have several redress possibilities.</p> <p><b>Ability to call meeting.</b> A general meeting may be called by the <i>conselho fiscal</i> may do so, as well as any shareholder, should the board fail to do so for more than 60 days. Additionally, shareholders representing 5 percent of capital may call a meeting whenever the board does not attend to their request, within 8 days. If the matter to be discussed is the establishment of a <i>conselho fiscal</i>, shareholders representing 5 percent of non voting “PN” shares may call a meeting.</p> <p><b>Ability to inspect books.</b> Shareholders owning 5 percent of capital may seek a court order to gain access to the company’s books if they suspect irregularities.<sup>82</sup></p> <p><b>Ability to set up a conselho fiscal.</b> Although legally mandatory, most <i>conselho fiscal</i> are not of permanent functioning, but are set up at the request of 5 percent “PN” shareholders or 10 percent “ON” shareholders for one fiscal year. 10 percent “ON shareholders” may nominate a <i>conselho fiscal</i> member; any “PN” shareholder may do the same.</p> <p><b>Withdrawal rights.</b> Law 10303 grants withdrawal rights to shareholders who dissent or abstain in the event of a merger, acquisition or spin-off. As to the spin-off cases, withdrawal rights only arise in case of a change of the nature of the company, reduction of mandatory dividends or participation in corporate groups.<sup>83</sup> Companies may establish criteria in the by-laws to determine an “economic value” or simply use book value for the terms of the withdrawal rights.</p> <p><b>Ability to challenge shareholder resolutions.</b> Shareholders have the right to challenge decisions taken by the AGM or the board if they are prejudiced by the decision or if the decision breaches any law or the bylaws.<sup>84</sup></p> <p><b>Power to postpone an AGM.</b> Instruction 372 grants CVM the power to postpone the AGM, if the matters to be discussed are complex and warrant more time than the usual 15 days’ advance notice. CVM may also suspend for up to 15 days a meeting that was already called, if it deems that a proposed issue violates any law or regulation.</p> <p><b>Court Redress.</b> Shareholders may file suits against (a) other shareholders; (b) company executives and directors; (c) the company; (d) the controlling company. CVM may assist aggrieved shareholders by collecting evidence and/or issuing legal opinions. These opinions are a powerful weapon to pressure companies to desist from certain dubious practices and can be used in court. Shareholders representing 5 percent of capital can initiate derivative action, in the case the shareholders meeting decides not to lodge an action.<sup>85</sup> The recovery goes to the company and the latter indemnifies the shareholder for expenses incurred. It is theoretically possible to lodge a class action suit (<i>ação civil pública</i>) through the public prosecutor (<i>Ministerio Público</i>).<sup>86</sup> However, in practice, class</p>

<sup>81</sup> Article 136 of Corporation Law

<sup>82</sup> Article 105 of Corporation Law.

<sup>83</sup> Article 137, III, of Corporation Law.

<sup>84</sup> Articles 115, 117, 159, 286 and 287 of Corporation Law.

<sup>85</sup> Article 159 of Corporation Law.

<sup>86</sup> Class Action is regulated b Law Number 7,347/85 and 7,913/89.

	<p>actions are not used for shareholder redress issues.</p> <p><b>Regulator Redress.</b> Shareholders may file for administrative proceedings with CVM. CVM imposed more than 5400 fines over 2001-3, of which 1597 were collected.<sup>87</sup> The bulk of these fines was imposed in regular administrative proceedings (which are of a different nature than punitive administrative procedures) and resulted in non-compliance with a CVM order, and averaged US\$1,000 each. Administrative inquiries or punitive administrative procedures resulted in 313 fines, the highest of which was US\$22.4 million (US\$220,935 on average). 267 of those were appealed,<sup>88</sup> and only 57 were collected averaging just US\$2,000. The highest permitted fine is R\$ 500.000,00, or 50 percent of the transaction. Such amounts may triple in the case of re-occurrence. In 2004, total fines collected amounted to \$931 million in non-compliance fines and US\$243 million in punitive fines. Fines are not the gravest penalties applied as a result of punitive administrative procedures. The CVM may also impose prohibitions, suspensions, or disqualifications.</p> <p>BOVESPA enforcement is active, with 54 trading suspensions in 2004.<sup>89</sup> BOVESPA reviews company information and transactions on an ongoing basis, and “cancelled” 7,146 transactions with atypical price and volume on its own and 1930 by demand of brokers. It sent 29,652 atypical transactions to auction in 2004. By way of preventative action, it received 1954 formal clarification requests from companies, sent 208 reports to CVM, and performed a number of audits of broker firms.<sup>90</sup></p>
(3) Custodian voting by instruction from beneficial owners.	Custodians are regulated by CVM instruction 89, which is in the process of being updated. Custodians send the GM notice / agenda to beneficiaries and can only vote if specifically instructed to do so by beneficiaries.
(4) Obstacles to cross border voting should be eliminated.	As regards Depositary Receipts, it is common for the depositary bank to give discretionary powers to a person or the custodian bank. <sup>91</sup> The GM notice period of 15 days is too short for depositary banks to collect voting instructions from beneficiaries. Part of this delay is explained by the process of proxy soliciting by the depositary bank and the receipt thereof by the custodian bank
(5) Equitable treatment of all shareholders at GMs	“PN” shares may attend GMs but cannot vote. Non-voting “PN” shareholders of companies listed on <i>Nível II</i> obtain voting rights in certain circumstances, such as transformation, spin-off and merger of the company, approval of contracts between the firm and other firms of the same group and other matters involving possible conflicts of interest between controlling shareholders and the company.
<b>Principle IIIB: Insider trading and abusive self-dealing should be prohibited.</b>	
<b>Assessment: Largely observed</b>	
<p><b>Basic insider trading rules.</b> The company, controlling shareholders, board and <i>conselho fiscal</i> members, management, and anyone who knows insider information because of their position in the company or controlled / controlling / associated company, or other people with access to insider information, such as auditors, analysts, consulting firms, banks, must not trade company shares before material events, or 15 days prior to quarterly information release. CVM resolution 358 recommends that companies internally adopt a trading policy, which includes longer black-out periods for board members and controlling shareholders. There are also special insider information provisions applicable until the filing of public offerings (quiet and black-out periods) and during the course of the offer.<sup>92</sup></p> <p>Management, directors, controlling shareholders, employees, and members of the <i>conselho fiscal</i> must not divulge information obtained by virtue of their position that will affect the value of the company, and cannot use the information to benefit themselves or a third party. Remedies include liability for loss and damages.<sup>93</sup></p> <p><b>Insider trading disclosure.</b> Directors and senior executives must disclose their shareholdings in the company and related companies upon appointment and at the GM, as well as to the CVM immediately upon a change in stockholding.<sup>94</sup> Senior</p>	

<sup>87</sup> 2378 – 2001; 1347 – 2002; 1697 – 2003. Of those, 609 were collected in 2001, 420 in 2002, and 568 in 2003.

<sup>88</sup> 20 were reversed, 90 maintained, and 108 modified in final rulings (the balance are pending).

<sup>89</sup> 54 suspensions in 2003, 91 in 2002, and 229 in 2001

<sup>90</sup> Data from OECD “Legal, Regulatory and Institutional Framework for Enforcement Issues in Latin America: A comparison of Argentina, Brazil, Chile, Colombia, and Peru.” October 2004.

<sup>91</sup> Reportedly, the representative of ADR holders often has instructions to vote with management.

<sup>92</sup> Article 48 of Instruction 400/03.

<sup>93</sup> Article 155, Article 9 of CVM instruction 358

<sup>94</sup> Article 157 of Corporation Law, Article 11 of Instruction 358/02. Information must be provided for each type and class of security that was traded, with disclosure for the total amount of securities as well as the percentage it represents of the class and type. Moreover, it must be disclosed the characteristics of the securities and also the broker-dealer which intermediate the operation, the day of the operation, the

management and directors must inform CVM and BOVESPA when they or their spouses and dependents buy or sell shares of the company or another public company of the same group.<sup>95</sup> This disclosure must take place within 10 days following the month when the transaction took place. For companies listed on *Level II* or the *Novo Mercado*, this obligation also extends to controlling shareholders. The CVM website contains monthly disclosures on purchases and sales of stocks by insiders, reported in the aggregate for the family group and related persons, the board of directors, all officers, the statutory auditor board, as well as for any other technical and advisory boards.

**Criminal/civil/administrative penalties.** Law 10,303 converts insider trading and abusive self-dealing into a crime subject to a fine of up to three times any gain obtained or loss avoided and a prison term of one to five years.<sup>96</sup> Since 1977, CVM investigated 31 insider-trading allegations, 20 of which were fined.<sup>97</sup> CVM also tends to impose more serious punishments, such as disqualification, prohibitions and suspensions (sometimes in addition to the fines) that have a major moral suasion impact. BOVESPA monitors insider trading for the 47 companies listed on the corporate governance segments. In 2004, CVM initiated 8 punitive administrative procedures involving insider trading accusations.

**Principle IIIC: Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.**

**Assessment: Partially observed**

**RPT approval rules/rules for approval of board/AGM.** The definition of related party transactions is not clearly stated in the legislature, but has been elaborated on by the CVM as “a transaction with parties where the conditions could potentially not be arm’s length” (CVM Deliberation nº 26/86). Management and directors may not favor affiliates or controlling entities in detriment of the company and must ensure that any transaction between related parties is conducted at arm’s length. Infringement with this provision carries liability. Board approval of related party transactions is not mandatory.

Related loans are generally forbidden (Article 154), though GM/bylaws may authorize board members to receive loans or to use firm property and services<sup>98</sup> Such contracts then by law must occur under reasonable and equitable conditions. Further, if the board of directors has to be heard in such cases, the related insider is forbidden to intervene in any way (Article 156).

**Conflict of interest rules and use of business opportunities.** Management and directors must not use business opportunities belonging to the company to their personal advantage, and are expected to seize any commercial opportunity advantageous for the company.<sup>99</sup>

#### SECTION IV: THE ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE

**The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.**

**Principle IVA: The rights of stakeholders that are established by law or through mutual agreements are to be respected.**

**Assessment: Observed**

**List of relevant codes for stakeholders.** Controlling shareholders and the board are expected to use their power to perform the company’s social role.<sup>100</sup> In this sense, their duties and responsibilities extend to employees and the community at large. *Instituto Ethos* is a NGO specialized on advising companies with regards to stakeholder relations and socially responsible behavior. Bribery is prohibited. With respect to human rights, the Brazilian legislation is considered advanced.

**Principle IVB: Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.**

**Assessment: Observed**

**Redress mechanisms available to stakeholders.** Stakeholders can obtain redress for violation of their rights, provided that they are directly affected. They can sue the company, the controlling shareholder or senior management based on the legal principle of civil liability. Article 186 of the amended Civil Code states that “anyone who, by voluntary action or

price, volume and traded amount. You may choose to consult the information on an individual basis (for each person required to disclose) or on a consolidated basis (in bulk). If no trading occurred, such information must be given.

<sup>95</sup> CVM Rule 358, of January 3, 2002, as amended by CVM Rule 369/2002, Article 11.

<sup>96</sup> Article 27-D of the Securities Law as amended by Law 10303, of October 31, 2002

<sup>97</sup> Source: *O Globo* newspaper, April 29, 2002.

<sup>98</sup> Article 154, § 2, “b” and “c” of Corporation Law

<sup>99</sup> Article 155 of Corporation Law

<sup>100</sup> Article 154 of Corporation Law

omission, negligence or imprudence, violates the right or causes harm to another, even just moral harm, gives cause to an illegal act".

**Principle IVC. Performance-enhancing mechanisms for employee participation should be permitted to develop.**

**Assessment: Largely observed**

**Rules on employee stock option plans.** Profit sharing programs are mandatory. Workers' representatives select an objective, e.g. profits, sales, reduction in overhead costs or receivables, as the benchmark. Some companies link senior executive compensation to the concept of "economic value added". Bylaws may provide for stock options.<sup>101</sup> The amount must be within the limits of authorized capital and the plan must be approved by a general meeting. CVM instructions 358/369 consider the creation and modification of stock option plans and the exercise of options a material event.<sup>102</sup> Companies must disclose stock option information in the notes to the yearly and quarterly financial statements. Outstanding stock options must be reported to CVM in the IAN.<sup>103</sup>

**Principle IVD: Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.**

**Assessment: Largely observed**

**Annual report discloses economic and financial prospects.** Not required by law. Article 8 of Instruction 202 gives the company the option of disclosing forward-looking statements, and sets forth the rules that may be observed when such projections are disclosed.

**Annual report discloses significant facts on employees.** Beyond the general discussion of the company and the total number of employees in the prospectus and the quarterly reports, there is no provision for filing employee information. IBASE (*Instituto Brasileiro de Análise Sociais e Econômicas*) developed a voluntary "social balance sheet" for companies to publish together with the financial statements. In this balance sheet the company provides a number of internal and external social and environmental indicators, information regarding employees, and corporate citizenship.<sup>104</sup>

**Information is timely and regular.** The publication of a social balance sheet is not mandatory, but some investors request it from their portfolio companies. PREVI, for example, reportedly considers requiring the publication of a social balance sheet from all companies they invest in.

**Principle IVE: Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.**

**Assessment: Largely observed**

**Whistleblower rules.** There are no mandatory whistleblower rules. In practice, any employee of a listed firm can file an anonymous complaint with CVM and CVM will investigate. This is quite common in practice.

**Principle IVF: The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.**

**Assessment: Partially observed**

**Effectiveness of bankruptcy, security/collateral, and debt collection/enforcement codes.** Debt recovery and covenant enforcement are difficult in Brazil. Negative credit reporting is provided by Serasa, but there is no other information, e.g. on all outstanding loans of a borrower.

In the past, insolvency procedures have been slow and have favored liquidation. The new bankruptcy law was signed in February 2005. The law introduces the concept of recovery – bankruptcy now can be the basis for restructuring rather than liquidation. It represents significant improvements e.g. in the area of priority of labor claims: The law also introduces a limitation in the privilege of labor claims. The priority is capped in order to protect employees rather than exorbitant claims by incumbent management. Claims over and above the cap are treated like any other creditors. In addition to that, the government has submitted to public hearing the project of a "Consumer Protection Data-Base Bill", which envisages enhancing credit granting mechanisms and also providing more reliability and protection to consumers.

<sup>101</sup> Article 168 of Corporation Law, paragraph 3

<sup>102</sup> CVM Rule 358, of January 28, 2002, as amended by CVM Rule 369/2002

<sup>103</sup> Copies of stock option plans must be delivered to Bovespa for companies listed on *Nivel I* and above.

<sup>104</sup> Approximately 250 companies, including Itaú, Petrobras and Companhia Vale do Rio Doce, reportedly use this methodology.

## SECTION V: DISCLOSURE AND TRANSPARENCY

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

Principle VA: Disclosure should include, but not be limited to, material information on:

Assessment: *Partially observed*

(1) Financial and operating results of the company	<p><b>Annual and quarterly reports.</b> Public firms file with CVM and BOVESPA and publish annual audited financial statements in the official gazette<sup>105</sup> plus a widely circulated newspaper, one month before the AGM and no later than four months after the end of the fiscal exercise.<sup>106</sup> According to CVM instruction 358, firms may opt to publish summaries, if the full information is available on the company website.<sup>107</sup> Financial and operating results include balance sheet, income statement, statements of changes in stockholder equity and financial position,<sup>108</sup> notes, management and audit reports.<sup>109</sup> Cash flow statements are not mandatory. The quarterly reports (which are <a href="#">generally reviewed by independent auditors, according to Article 1<sup>st</sup>, I-b, of Instruction CVM nº 245/96</a>) are filed with CVM and BOVESPA within 45 days. Firms listed on the corporate governance segments adhere to stricter disclosure requirements.</p> <p>While BOVESPA monitors filings for technical errors, it does not analyze content in depth. It can ask the company to correct errors and, in cases of serious non-compliance, suspend trading or de-list. Five companies were de-listed in 2002 for non-provision of financials, 4 in 2003, and 2 in 2004. BOVESPA can also fine issuers on the special corporate governance segments for non-compliance. In 2002, 10 companies were fined and in 2003 – 4, there were no fines in 2004. In 2004, CVM initiated 6 punitive administrative procedures against company directors and management, for disclosure violations. The recent upgrade of CVM disclosure monitoring procedures has resulted in more in-depth analysis of disclosure content.</p>
(2) Company objectives	Companies listed on <i>Nível I</i> or above disclose an annual calendar of corporate events.
(3) Major share ownership and voting rights	The capital structure, including rights of “PN” shares, is reflected in the annual report. Ownership of more than 5 percent of voting capital is disclosed in the IAN. <sup>110</sup> IAN also shows indirect ownership, i.e. the shareholding composition of the parent companies, even if they are not public. While this helps tracking down ownership, shareholder agreements and fronting add another layer, especially where offshore companies are involved.
(4) Remuneration policy for board and key executives, and information about directors	Information on the aggregate compensation package is available from AGM minutes, because shareholders approve the package. Disclosure of individual compensation is rare, allegedly because of fear that it would expose executives to blackmail, or to industry competition. CVM is studying avenues for enhanced compensation disclosure.
(5) Related party transactions	Pursuant to CVM Deliberation 26, public firms disclose RPTs in form IAN and the notes to the financial statements. Most firms do not provide details in addition to the value of the transaction. Market participants consider RPT disclosure less than adequate.
(6) Foreseeable risk factors	Annual reports do not include a detailed management discussion and analysis chapter.
(7) Issues regarding employees and other stakeholders	There are no rules for disclosure of employee and stakeholder issues in the annual report. Companies may opt to publish a social balance sheet reflecting employee issues.

<sup>105</sup> Depending on where the company is incorporated, this can represent an important expense.

<sup>106</sup> Article 132 and 175 of Corporation Law.

<sup>107</sup> Information with CVM is filed in standardized electronic formats known as *Demonstrações Financeiras Padronizadas* (DFP) and *Informações Anuais* (IAN).

<sup>108</sup> Companies listed on *Nível I* and above must submit cash flow statements.

<sup>109</sup> Additional quarterly and annual disclosure requirements apply to companies listed on *Nível I* and above. For companies on *Nível II* and the *Novo Mercado*, the quarterly information must be submitted in English or under IAS.

<sup>110</sup> CVM instruction 202, Article 7.

(8) Governance structures and policies	Theoretically, listed firms are expected to disclose their adherence to the comply-or-explain corporate governance code issued by CVM. <sup>111</sup> In practice, this is not enforced.
<b>Principle VB: Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.</b>	
<b>Assessment: Partially observed</b>	
<p><b>Compliance with IFRS.</b> In addition to CFC, CVM, Banco Central and other sector regulators issue accounting standards for listed companies. [Suppressed because the Central Bank does not necessarily need to follow the Corporation Law to enact its accounting rules]. Brazilian GAAP differs materially from IFRS, including the absence of mandatory cash flow statements, segment reporting and business combination disclosures. Companies listed on <i>Nivel II</i> and the <i>Novo Mercado</i> must adopt US GAAP or IFRS. Draft bill 3741 proposing an overhaul of the disclosure regime, has been pending approval in Congress for the past 5 years. Further information on accounting, financial reporting, and auditing standards can be found in the Accounting &amp; Auditing ROSC conducted by the World Bank in 2005.</p> <p><b>Review/enforcement of compliance.</b> CVM is the main enforcer of public firms' compliance with disclosure requirements.<sup>112</sup> It can inspect companies, giving priority to those that do not generate profit in their balance sheets, or fail to pay the minimum dividend, and where the auditor opinion contains reservations or emphasis notes, as well as considering the size of the company and the dispersion of its shareholders.<sup>113</sup> According to survey results, 92 percent of listed firms publish financial reports by the required date and 38 percent use US GAAP or IFRS.<sup>114</sup></p>	
<b>Principle VC: An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.</b>	
<b>Assessment: Partially observed</b>	
<p><b>Compliance with ISA.</b> IBRACON adopted voluntary audit guidelines similar to ISA. There is no independent auditor oversight body and CFC does not have the clout to enforce quality standards. [Comment: ISA does not require the creation of an independent body to supervise auditors. Moreover, the text gives the impression that there is no audit supervision in Brazil, which is not true and fair in light of the role that CVM and Central Bank play on this subject]</p> <p><b>Who must be audited.</b> The financial statements of public SAs must be audited by an independent auditor. About 82 percent of listed firms use one of the leading global audit firms.<sup>115</sup></p> <p><b>Auditor independence.</b> CFC defines independence as "not being influenced by facts, prejudice or other elements that result in loss of independence".<sup>116</sup> Family relationship with, and share ownership of the audited firm and related companies are prohibited.<sup>117</sup> Listed companies are required to rotate auditing firms every five years.<sup>118</sup> A CVM ban on conducting audit and consulting services for the same firm, if that could result in the loss of independence, was appealed;<sup>119</sup> a preliminary injunction was granted.<sup>120</sup> CVM ruling 381 requires firms to disclose the total value of the audit fees and its percentage as compared to the non-audit fees, if these represent more than 5 percent of the total invoice.<sup>121</sup></p> <p><b>Audit committee.</b> Audit committees are not mandatory for listed companies, except banks. Banking resolution 3198 of 2003/04 requires banks beyond a certain size to establish an "audit committee". This committee is not a subcommittee of the board, even though some of its members are directors. All audit committee members are subject to Central Bank fit and proper criteria, as well as additional criteria – financial proficiency for at least one member. The audit committee reviews financial statements, reports to the board, and its members are liable. A short report of the audit committee is published in the annual report, and the full report is kept at company headquarters and can be requested by the Central Bank. Audit committee pay is higher than director pay.</p>	

<sup>111</sup> Instruction 202.

<sup>112</sup> Except banks.

<sup>113</sup> The CVM is enforcing this obligation by selecting for in investigation / check, at a first pass, companies who have received a qualified or otherwise annotated auditor's opinion, as well as considering the size of the company and the dispersion of its shareholders.

<sup>114</sup> André Carvalhal-da-Silva and Ricardo Leal: "Corporate Governance Index, Firm Valuation and Performance in Brazil"

<sup>115</sup> André Carvalhal-da-Silva and Ricardo Leal: "Corporate Governance Index, Firm Valuation and Performance in Brazil"

<sup>116</sup> CFC Rule NBC P 1, article 1.2 (Technical Interpretation NBC T 11-IT-01)

<sup>117</sup> CVM instruction 308

<sup>118</sup> 5 years also in the case of banks. CVM instruction 308 was published in 1999 and went into effect in 2004.

<sup>119</sup> Prohibited advice includes, without limitation: (i) corporate restructuring; (ii) valuations; (iii) asset revaluation; (iv) technical reserves and contingency provisions; (v) tax planning; (vi) remodeling of accounting, information and internal control systems; or (vii) any other service that influences decisions of the audited entities.

<sup>120</sup> A final decision is pending.

<sup>121</sup> Instruction 381, Article 2, II.

**Requirements for oversight of audit.** The board appoints the auditor; GM confirmation is not required. CFC and the Regional Councils of Accounting<sup>122</sup> employ inspectors who compare financial statements against a basic checklist. This is meant to ensure quality oversight. However, despite sanction powers, CFC lacks capacity and incentives to penalize colleagues.<sup>123</sup> The audit profession is not separately regulated; IBRACON has no disciplining powers and no legal backing. The CVM supervises independent auditing of non-financial listed companies.

**Audit enforcement competent/qualified.** The Institute of Independent Auditors<sup>124</sup> estimates that there are 350,000-380,000 accountants and accounting technicians in Brazil, but, among these, 400 (individuals and legal entities herein included) are registered in the CVM to provide independent auditing services, and about 40% of these have clients and do really participate in the capital market.. CVM ruled 18 punitive procedures involving auditors since 2002. In this same period, the technical area of CVM examined 121 more cases, which have resulted in 29 warning letters and in 15 new punitive procedures. Interviews reveal a concern by market participants as to auditing quality. [The CVM also understands that enforcement is not the better tool to improve quality. We think that this would be better achieved through peer review and continued education programs, and also by qualification tests.]

**Auditor qualifications.** CFC licenses accountants. Requirements include a bachelor degree in accounting and a multiple-choice exam. CVM instruction 308/1999 grants CFC the power to (i) issue auditor examination standards; (ii) conduct technical exams on behalf of CVM; (iii) issue standards for continuous professional education; (iv) conduct peer reviews; (v) conduct internal quality controls of audit firms.<sup>125</sup> The first technical exam was conducted in the fall of 2004. The pass/fail ratio was over 90 percent “pass”. In addition to the exam, before registering with CVM, the auditor must prove compliance with the other requirements of Instruction CVM 308/99 (for instance, to have a five-year period of experience). Only after that the register is granted and the auditor may audit public companies.

**Statutory auditors or similar company organs.** The regulatory framework requires public companies to provide for the existence of a *conselho fiscal* (statutory auditor board) with between 3-5 members; despite of its mandatory existence, the functioning of *conselho fiscal* can be transitory or permanent. The *conselho fiscal* is not a board committee<sup>126</sup> and its members must not be officers, directors (even though they have the same liability as directors), or employees of the company, or relatives or spouses of any officer or director.<sup>127</sup> These requirements are supervised by the CVM, which has issued Parecer de Orientação nº 19, elaborating on this subject.

Requirements include a university degree. Their remuneration is set as a percentage of total management compensation (10 percent). *Conselho fiscal* have wide powers to supervise management and the board, oversee financial reporting, consult with external auditors, issue opinions on major corporate transactions, and call the AGM.<sup>128</sup> They can put directors or managers under criminal investigation. *Conselho fiscal* members are obliged to denounce fraud, accounting misconduct, or any wrongdoing to the board, and if the board does not take action, to the GM. Law 10,303 gives each individual member the power to act individually; the final report presented to the board and the AGM must be approved by each and every member.

While there is doubt that the *conselho fiscal* can fulfill its wide mandate in practice, *conselho fiscal* are popular among “PN” shareholders and pension funds – PREVI, for example requires that their portfolio companies install permanent *conselho fiscal*.<sup>129</sup> It is relatively easy for “PN” shareholders to nominate a representative to the *conselho fiscal* and, even though the controller appoints the majority of its members, the power to act individually strengthens the role of minorities, who tend to be active. “PN” shareholders view the *conselho fiscal* as their main weapon to monitor controlling shareholders.

**Principle VD: External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.**

**Assessment: Partially observed**

**Auditor accountability.** It is the duty of the board to hire the independent auditor. This decision is subject to the veto of the directors elected by minority shareholders.<sup>130</sup> The AGM does not confirm the appointment of the auditor. It is the responsibility of the external auditor to tell the board if they notice any infraction, but if the board takes no action, there is no obligation for the auditor to seek outside redress.

**Auditor liability.** Auditor liability is well defined in the law, and there have been cases in relation to listed companies. For example, to take the past three years, the CVM has issued, in punitive procedures, one warning, two suspensions, one disqualification, and seven cases where the auditors involved were fined. In this same period, the technical area of CVM examined 121 more cases, which have resulted in 29 warning letters and in 15 new punitive procedures.

<sup>122</sup> *Conselhos Regionais de Contabilidade*

<sup>123</sup> E.g. CFC has imposed no sanctions in 2004

<sup>124</sup> *Instituto dos Auditores Independentes do Brasil* (IBRACON)

<sup>125</sup> The rules are compiled in Instruction 308/99.

<sup>126</sup> However, the US SEC accepts a permanently installed *conselho fiscal* as a substitute for an audit committee for Brazilian ADRs.

<sup>127</sup> Article 162, §2<sup>nd</sup>, of Corporation Law.

<sup>128</sup> Article 163 of Corporation Law

<sup>129</sup> Black et al (2005), “Corporate Governance Index in Brazil” finds that 46% of the listed firms have permanent statutory auditor boards.

<sup>130</sup> Article 142 of Corporation Law

<b>Auditor insurance.</b> Not required by law and not widely used in practice, outside of multinational audit firms.
<b>Principle VE: Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.</b>
<b>Assessment: Observed</b>
<p><b>Material events.</b> CVM and BOVESPA require immediate announcements of material events that may affect the market value of a firm. In practice, companies disclose material events whenever possible before markets open or after they close. During the day, trading may be suspended.<sup>131</sup> Management may request CVM to waive this obligation, on grounds that the information would put at risk the legitimate interests of the firm.<sup>132</sup> The CVM weighs the waiver request on its merits, and, in the case it denies the request, the company must give immediate disclosure to the material event.</p> <p><b>Published information (papers, web).</b> Information submitted to CVM<sup>133</sup> and BOVESPA is publicly available – often through the internet. Exceptions include minutes of general meetings, where hard copies are filed with CVM and the Commercial Registry, as well as AGM notices and material events, which are printed in newspapers or disseminated electronically. Shareholders may request hard copies of public documents from CVM, without restrictions or costs.</p> <p>Public corporations must publish financial statements in major newspapers and in the local official gazette (<i>Diário Oficial</i>) where they are incorporated. Some of the gazettes reportedly charge exorbitant prices – so stiff that publication costs are cited amongst the reasons for delisting.<sup>134</sup> Some annual reports are available on company websites.</p>
<b>Principle VF: The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice.</b>
<b>Assessment: Partially observed</b>
<p><b>Disclosure of conflicts of interest by analysts, brokers, rating agencies, etc.</b> Brokers, asset managers, and underwriting activities are typically carried on by banks. The brokerage / analyst subsidiaries are somewhat separated from asset management, as well as from the commercial bank. Specifically, financial intermediaries are allowed to perform several activities, as long as they have formal provisions of activity segregation. One of the most famous cases of 2004 was “Fator”, where the existing Chinese walls of Fator Group were deemed insufficient to impede insider trading among the divisions of this group. Instruction 388/02 (private securities analysts) requires intermediaries to be registered in CVM, to be affiliated and accredited by a professional organization authorized by the CVM, to adhere to a Code of Ethics, to pass a technical exam, and to be free from any conflict of interest. The same requirements apply to portfolio asset managers (ruled by the Instruction 306/99) and individual investment agents (ruled by Instruction 355/01).<sup>135</sup></p>
<b>SECTION VI: THE RESPONSIBILITIES OF THE BOARD</b>
<b>The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.</b>
<b>Principle VIA: Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.</b>
<b>Assessment: Partially observed</b>
<p><b>Basic description of board.</b> Public firms have a board of directors (<i>conselho de administração</i>) and a management board (<i>diretoria</i>); but they function as unitary boards.<sup>136</sup> Chairman and CEO functions are separated in more than half of the listed</p>

<sup>131</sup> CVM Rule 358, of January 3, 2002, as amended by CVM Rule 369/2002, Article 5.

<sup>132</sup> Article 157 (paragraph 5) of Corporation Law and article 6 of CVM instruction 358/02. This exception is often exploited according to local lawyers, notably in sensitive matters such as prospective divestitures and acquisitions. The waiver is not required should the management feel comfortable that the disclosure would injure or put at risk the legitimate interest of the company.

<sup>133</sup> Filings with CVM are electronic

<sup>134</sup> Ricardo Leal and André Carvalho-da-Silva: “Corporate Governance and Value in Brazil (and in Chile); 2004

<sup>135</sup> Instruction 400/03 (primary and secondary offerings) states the duties that need to be observed by intermediary institutions involved in a public offering, requiring them to provide fair and equitable treatment to investors, to check the correspondence of the investment vis-à-vis to the investors risk profile, and to perform a due diligence of the information contained in the prospectuses.

<sup>136</sup> The term *administrador* refers to the board of directors, management, members of Statutory Auditor Board, as well as to any body created in the by-laws in order to provide technical assistance or advice to the Board or to management (Article 160 of Corporation Law).

<sup>137</sup> Black et al (2005), “Corporate Governance Index in Brazil” find this figure to be 73 percent. They also find that board size varies between 3 and 22, or 7 members on average.

<sup>138</sup> Directors of companies listed on *Nível II* or *Novo Mercado* serve a unified term of one year, re-election permitted.

<sup>139</sup> André Carvalho-da-Silva and Ricardo Leal: “Corporate Governance Index, Firm Valuation and Performance in Brazil”

firms. <sup>137</sup> <b>Size requirements and typical size.</b> A minimum of three directors are elected for a term of up to three years, re-election permitted. <sup>138</sup> Typical boards have between 5-9 directors. The boards of firms listed on <i>Nivel II</i> or above are elected for one year only. Then the entire board stands down for re-election. In practice, this only happens in 26 percent of the firms. <sup>139</sup> <b>Nomination and election.</b> The AGM elects directors. <b>Eligibility requirements.</b> Directors must be shareholders. They must not hold a management or board position in a competing company, and must not have conflicts of interest with the company. <sup>140</sup> There are no minimum technical skills requirements.	
<b>Principle VIB: Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.</b>	
<b>Assessment: Partially observed</b>	
<b>Adequacy of duties of loyalty and care.</b> Directors owe care, diligence, loyalty and confidentiality to the company. <sup>141</sup> There is no specific rule for directors to treat shareholders equally. <sup>142</sup> Directors voting under shareholder agreements are constrained to vote per the agreement, and therefore in the interest of the shareholders signatories to the agreement. In voting, directors are nevertheless subject to general duties to serve the best interest of the company. In the case of abstention, the aggrieved party may vote the shares held by the silent director in accordance with the terms of the agreement. <sup>143</sup> If the shareholder agreement is not specific, the chairman of the board has the power to decide what matters fall under the agreement. This obligation potentially undermines the fiduciary duty to the company. <sup>144</sup> <b>Insurance for directors.</b> Director awareness about their responsibilities is increasing, in spite of lack of legal casework on director liability, in part because of the threat of CVM sanctions. There are no provisions regarding the purchase of liability insurance policies by firms on behalf of directors. In practice, few companies purchase such policies, but the trend is rising. <b>Business judgment rule/board accountability.</b> Directors should employ the care and diligence that an industrious and honest person employs in the administration of his own affairs. <sup>145</sup> They are not liable for actions taken in the normal course of business. <sup>146</sup> They are, however, liable when acting negligently, fraudulently or in breach of existing laws or by-laws.	
<b>Principle VIC: The board should apply high ethical standards. It should take into account the interests of stakeholders.</b>	
<b>Assessment: Largely observed</b>	
A board member shall use the powers conferred upon him by law and by the bylaws to achieve company objectives and fulfill the social role of the company. <sup>147</sup> Acting in the best interest of the company implies consideration of the public at large, including stakeholders. The large state owned pension funds and the Pension Fund Association <sup>148</sup> have adopted CSR rules and require that their portfolio companies comply with certain CSR conditions.	
<b>Principle VID: The board should fulfill certain key functions, including:</b>	
<b>Assessment: Partially observed</b>	
(1) Board oversight of general corporate strategy and major decisions	<b>Board functionality by law and in practice.</b> One of the board's key functions is to guide corporate strategy, review corporate actions and give an opinion on the management report. In practice, the boards of most firms do not yet play a central and strategic role, which is played instead by the controlling owner. <b>Director training, IOD.</b> The IBGC conducts regular director training programs.

<sup>140</sup> Article 147, §3<sup>rd</sup>, II of the Corporation Law.

<sup>141</sup> Article 154 of Corporation Law

<sup>142</sup> Under general Corporation Law, to which directors are also subject, shareholders of the same class must have the same rights (Article 109, §1<sup>st</sup>).

<sup>143</sup> Article 118 §8 of Corporation Law

<sup>144</sup> Article 118 §8, introduced by the 2001 Corporate Law reform, has created a potential contradiction in the corporate legal provisions in force, in particular with a view to paragraph 2 of the same article and paragraph 1 of Article 154 of Corporation Law, which remained unchanged in the reform. Specifically, board members are expected to act in the best interest of the company, which technically should oblige a board member to vote against a shareholder agreement voting instruction, which damages the interests of the company in any way, or he faces liability issues. The CVM interprets §8 as being superseded by this general duty of directors to safeguard company interests.

<sup>145</sup> Article 153 of Corporation Law

<sup>146</sup> Article 159 of Corporation Law. The company may be liable for damages to third parties, which arise as a consequence of these actions.

<sup>147</sup> Articles 153-155 of Corporation Law

<sup>148</sup> ABRAP

(2) Monitoring effectiveness of company governance practices	There is no explicit rule in the law on board monitoring of corporate governance practices.
(3) Selecting / compensating / monitoring / replacing key executives	Board functions include appointing key executives, defining their duties, determining their remuneration and reviewing executive performance.
(4) Aligning executive and board pay with long term company and shareholder interests	The AGM approves an overall package of director and executive pay, proposed by the board. The board then determines the allocation of the total sum among board members and executives.
(5) Transparent board nomination / election process	Directors are usually nominated by the insider-dominated board and confirmed by the AGM on a pro-forma basis. Minorities can appoint representatives, if they own the minimum percentage of capital required to do so. There is no detailed information available on newly nominated directors, however, the law requires that at election, the AGM is presented with sufficient information to ascertain the eligibility of directors, or alternatively a signed statement by the directors that they do comply by all legal requirements to become a director. <sup>149</sup>
(6) Oversight of insider conflicts of interest, including misuse of company assets and abuse in RPTs	Directors and executives cannot not interfere in transactions where they have a conflict of interest, nor participate in the decision making process. They must inform the board and record the nature and extent of the conflict in the board minutes - however, there is anecdotal evidence that the minutes rarely record such statements in detail. <sup>150</sup> Controlling shareholders are not allowed to vote (i) on resolutions related to the appraisal of in-kind contributions <sup>151</sup> , (ii) on the approval of financial statements, if it is they who prepared them, and (iii) in matters that may give cause to a particular benefit to him. Otherwise they are technically allowed to vote, provided that, if the vote was cast in harm of the company, it can be discussed “ <i>ex post</i> ” by any shareholder.
(7) Oversight of accounting and financial reporting systems, including independent audit and control systems	Key functions include the responsibility over company books and the hiring of the external auditor. <sup>152</sup> The Corporation Law stipulates that the management is responsible for the elaboration of the company’s financial statements, and that the CEO and CFO sign off financial statements (Articles 176 and 177, §4 of Corporation Law)
(8) Overseeing disclosure and communications processes	The board must appoint an “Investor Relations” officer, responsible for relations with investors and CVM, as well as for the major obligations established by the Instruction 358/02. <sup>153</sup>
<b>Principle VII: The board should be able to exercise objective independent judgment on corporate affairs.</b>	
<b>Assessment: Materially not observed</b>	
(1) Director independence	<p><b>Director independence in law.</b> There is no definition of “independence” in the law, nor does resolution 3041/2002 that deals with “fit and proper” criteria for banks, require independence. No more than one third of the members of the <i>diretoria</i> may serve on the board of directors.<sup>154</sup> However, nothing prevents senior executives with no seat on the <i>diretoria</i> from being directors.</p> <p><b>Director independence in practice.</b> A recent survey shows that only approximately 1/3 of the boards of listed firms are not made up of corporate insiders and that the vast majority of directors are beholden to the controlling shareholders.<sup>155</sup> Directors appointed by</p>

<sup>149</sup> Instruction CVM 367/02, Article 3<sup>rd</sup>. The eligibility requirements are noted in Articles 147 for the board of directors and 162 for the statutory fiscal board. See also Principle VIA.

<sup>150</sup> Board minutes must be publicly available, if the decisions affect third parties.

<sup>151</sup> Article 115 of Corporation Law

<sup>152</sup> Subject to the  *veto*  of the directors elected by minority shareholders (Article 142 of Corporation Law)

<sup>153</sup> CVM instruction 202, article 5

<sup>154</sup> Article 143, paragraph 1 of Corporation Law

<sup>155</sup> André Carvalhal-da-Silva and Ricardo Leal: “Corporate Governance Index, Firm Valuation and Performance in Brazil”

<sup>156</sup> CVM instruction 358/02 creates a “black out period” of 15 days before the release of quarterly results. Some asset managers interpret this instruction to prohibit them from trading, if a fund employee or partner sits on the board of the portfolio company. Thus, asset managers are starting to appoint independent directors.

	pension funds usually have a close relationship with the fund or the fund's sponsor, i.e. they are often current or former employees; and may therefore not be seen as independent. Some asset managers have been more active in promoting independent directors. <sup>156</sup>
(2) Clear and transparent rules on board committees	<p><b>Audit committees.</b> Audit, remuneration and other board committees are not mandatory nor common. Banks must have an "audit committee", but it is not a board subcommittee. Recently listed companies have started to explore the benefits of board committees.</p> <p><b>Other committees.</b> There is no legislative requirement or actual practice of establishing other board sub-committees.</p>
(3) Board commitment to responsibilities	<p><b>Restrictions on the number of board seats.</b> There are no rules regarding the number of board seats an individual may hold.</p> <p><b>Board meeting requirements.</b> There is no statutory requirement for the board to meet regularly. In practice, boards meet sporadically and directors do not devote sufficient time to their responsibilities.</p> <p><b>Public availability of board attendance.</b> Board attendance is not publicly available.</p>
<b>Principle VIF: In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.</b>	
<b>Assessment: Largely observed</b>	
Many corporate issues are decided outside the boardroom by the controller or the control block bound by a shareholder agreement. Non-executive or independent directors may not have unhindered access to relevant and timely information. The law does not expressly provide access to professional advice, but it does require in certain cases that, before being submitted to the GM, a Board proposition may be based upon technical advice.	

## Recommendations

### Mainstreaming Corporate Governance

Consideration should be given to increased director training, awareness-raising, and empowering of directors representing pension funds on boards of listed companies, which would greatly enhance their effectiveness. (e.g. the Chile experience could serve as a useful starting point).

Policymakers should fortify the bylaws of large listed SOEs so that they could migrate to the corporate governance segments, providing listed firms with a model to emulate.

Policymakers should consider ways to increase court specialization in commercial matters, as well as a strategy of training judges and improving the effectiveness and speed of the proceedings.

As the main long term lending institution, BNDES should revive its campaigns to promote good corporate governance, e.g. its "mileage" program which rewards certain corporate governance and transparency practices.

Best practice suggests that institutional investors, e.g. pension funds and asset managers, disclose their voting policy. Careful monitoring and enforcement of such practices is needed for effective results.

The market would benefit from Chinese walls and other provisions ensuring against conflicts of interest among investment advisers, analysts, brokers, rating agencies and other market participants. Careful monitoring and enforcement of such practices is needed for effective results.

### Strengthening shareholder rights

For withdrawal rights to provide minority protection in case of oppression, the right of a dissenting shareholder to sell shares to the company should be effectively assured at fair market value. Arbitrary determination of "economic" or book value may not assure adequate dissenting shareholder protection.

Policymakers should assure themselves whether 15 days of notice is adequate in all cases for purposes of voting at GMs, including in the case of foreign investors and depository receipts holders. In the long term, the current procedures for proxy voting, particularly but not only, in the case of foreign investors (notarization, certified translation, etc) are not consistent with modern capital market standards.

The introduction of proxy voting by mail will increase minority investor participation in corporate governance.

Tag-along rights for PN shares are suggested by good international practice as one of the main instruments for minority investor protection.

Shareholder access to the full shareholder list will ease communication among minority investors. Considerations of abuse of the information could be addressed in alternative ways, e.g. by only disclosing email addresses.

Off-exchange sales of control should be assured to occur at a fair price and comparable conditions to control changes executed on the stock exchange.. Best practice suggests that the target company board issue an opinion on the expected merger.

Policymakers should establish clear, bright line rules on how related party transactions should be approved and disclosed. A mechanism of credible monitoring of compliance with RPT rules should complement such efforts.

### Providing transparency and disclosure

The annual report content should be clearly determined in current legislation. Annual reports, per best practice, include cash flow statements, segment reporting, and a detailed management discussion and analysis chapter.

Accounting and auditing standards require an update to the level of international standards. Detailed accounting and auditing recommendations, including a commentary on the *Projeto de Lei 3741* and the width of its application on *limitadas*, can be found in the Accounting and Auditing ROSC 2005.

### Promoting effective boards

Policymakers should periodically assess the corporate governance conditions in the country, to determine the need and appropriateness for fully-independent audit committees as part of the board of directors, per international standards. It is currently CVM's opinion that *conselho fiscal* needs a test stage before passing judgment on its effectiveness, as there is no evidence so far that audit committees in the case of Brazil would render benefits that would outweigh the costs thereof to

the company. When such reforms are eventually undertaken, banks may be a likely segment to spear-head the initiative of introducing independent directors. The formation of other board committees may be mandated. These measures would result in boards performing a central and strategic role in the governance of companies. At the current time, however, *conselho fiscal* may provide a feasible and workable tool in the audit board committee stead.

The AGM approves an overall package of director and executive pay, proposed by the board. The board then determines the allocation of the total sum among board members and executives.

More detailed information should be made available on newly nominated directors, over and above the requirements of CVM Instruction 367/02.

Directors best service company interests by treating shareholders equally. Shareholder agreement provisions explicitly requiring directors to act in the interest of a certain group of shareholders potentially undermine the fiduciary duty of directors to the company.

Rules on frequency of board meetings will serve to encourage directors to devote sufficient time to their responsibilities.

Companies listed on Level II or Novo Mercado should establish full audit committees as part of their board of directors.

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# Brazil Terms/Acronyms

<b>AGM:</b> Annual General Shareholders Meeting
<b>BNDES:</b> Banco Nacional de Desenvolvimento Econômico e Social, Brazilian Development Bank.
<b>BOVESPA:</b> Bolsa de Valores de São Paulo, Brazil's stock exchange
<b>CBLC:</b> Brazilian Clearing and Depository Corporation
<b>Conselho de Recursos do Sistema Financeiro Nacional (CRSFN):</b> National Financial System Appeal Council.
<b>Conselho Fiscal:</b> A group or "board" of statutory auditors
<b>Cumulative voting:</b> Cumulative voting allows minority shareholders to cast all their votes for one candidate. Suppose that a publicly traded company has two shareholders, one holding 80 percent of the votes and another with 20 percent. Five directors need to be elected. Usually, each shareholder must vote separately for each director. The majority shareholder will get all five seats, as s/he will always outvote the minority shareholder by 80:20. Cumulative voting would allow the minority shareholder to cast all his/her votes (five times 20 percent) for one board member, thereby allowing his/her chosen candidate to win that seat.
<b>CVM:</b> Comissão de Valores Mobiliários, Brazil's securities regulator
<b>IAN:</b> Informações Anuais – Annual report submitted to the securities regulator
<b>IBGC:</b> Instituto Brasileiro de Governança Corporativa – The Brazilian Institute of Corporate Governance
<b>ISA:</b> International Standards on Auditing
<b>IFRS / IAS:</b> International Financial Reporting Standards (before: International Accounting Standards)
<b>Nível I, Nível II, and Novo Mercado:</b> Corporate Governance Market Segments
<b>"ON" shares:</b> Ordinary shares; see also "PN" shares.
<b>"PN" shares:</b> "PN" non-voting shares are comparable to non-voting, perpetual, common equity. Unlike preferred shares in other jurisdictions, the law did not originally grant "PN" shares rights that would convert them into quasi debt instruments; since 2001 companies must grant them one of three options: (i) priority in dividends corresponding to at least 3 percent of the net equity value per PN share; (ii) "tag along" rights at 80 percent of the price paid to the controlling shareholder in a change of control or (iii) dividends at least 10 percent higher than the dividend paid to common "ON" shares.
<b>Pre-emptive rights:</b> Pre-emptive rights give existing shareholders a chance to purchase shares of a new issue before it is offered to others. These rights protect shareholders from dilution of value and control when new shares are issued.
<b>Proportional representation:</b> Proportional representation gives shareholders with a certain fixed percentage of shares the right to appoint a board member.
<b>Pyramid structures:</b> Pyramid structures are structures of holdings and sub holdings by which ownership and control are built up in layers. They enable certain shareholders to maintain control through multiple layers of ownership, while at the same time sharing the investment and the risk with other shareholders at each intermediate ownership tier.
<b>RPT:</b> Related party transactions. The OECD Principles of Corporate Governance hold that it is important for the market to know whether a company is being operated with due regard to the interests of all its investors. It is therefore vital for the company to fully disclose material related party transactions to the market, including whether they have occurred at arms-length and on normal market terms. Related parties can include entities that control or are under common control with the company, and significant shareholders, such as relatives and key managers.
<b>Shareholder agreement:</b> An agreement between shareholders on the administration of the company, it typically covers rights of first refusal and other restrictions on share transfers, approval of related-party transactions, and director nominations.
<b>Squeeze-out right:</b> The squeeze-out right (sometimes called a "freeze-out") is the right of a majority shareholder in a company to compel the minority shareholders to sell their shares to him. The sell-out right is the mirror image of the squeeze-out right: a minority shareholder may compel the majority shareholder to purchase his shares.
<b>Tag-along rights:</b> The right of minority shareholders to sell their shares in a change of control on the same terms as the controlling shareholder.
<b>Withdrawal rights:</b> Withdrawal rights (referred to in some jurisdictions as the "oppressed minority," "appraisal" or "buy-out" remedy) give shareholders the right to have the company buy their shares upon the occurrence of certain fundamental changes in the company.

This report is one in a series of corporate governance country assessments carried out under the Reports on the Observance of Standards and Codes (ROSC) program. The corporate governance ROSC assessments examine the legal and regulatory framework, enforcement activities, and private sector business practices and compliance, and benchmark the practices and compliance of listed firms against the OECD Principles of Corporate Governance.

The assessments:

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