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Session 6: A Scenario for Achieving More Effective Enforcement – The Roles and Responsibilities of Different Players

I would like to set a different tone here. We all – and especially us Brazilians – seem to be patting ourselves on the back for the excellent job we`ve done in reforming our capital markets regulations. And don`t get me wrong – we`ve come long way indeed. The market is up, volume is up, the IPO market is back, and we are cited worldwide as a successful example of improving both regulation and self regulation, especially with the Novo Mercado.

However, I would argue that the job is not done. We have barely scratched the surface of reforming what needs to be reformed. I would argue that not only has reform halted too early, but also that we are facing a significant backlash against reform. The sensation of accomplishment, together with this backlash risk transforming Brazil from a leader into a laggard in terms of capital market reform.

To try to explain this view, I would like to refer to the reform priorities listed in the White Paper. Where do we stand, and what are the challenges of reform and – more specifically enforcement – for the next few years ? Let`s take a closer look.

1. Taking voting rights seriously

Shareholder meetings are becoming more significant. Regulators took important steps in the direction of disclosure of voting practices by pension and mutual funds. However, these rules have not reduced absenteeism in general meetings. There is not yet a perception that voting rights are an asset of the funds, and that managers should in principle, exercise it. Worse still, we are starting to detect corporate pressure on investment managers, introducing in Brazil a typical US problem, that until now didn`t exist. I see a major role for Anbid, which is co-sponsoring our meeting today – in this issue, as well as for the CVM and investors themselves.

Another issue is that logistics for the meetings, and the quality of information in the notices need to improve. Companies can do it on a voluntary basis, but in my opinion the CVM does have the power to mandate better disclosure prior to meetings.

2. Fair Treatment in change of control and delisting.

IN 361 was a major development and it is working well. Besides, almost 50 companies have voluntarily granted tag along rights. The IBGC reviewed its recommendation on tag along, focusing on the equity of the treatment, and allowing for proportional offers. I encourage you to take a look at it on the Code that was distributed here.

However, the loopholes are starting to appear, and the issue of merger of shares is clearly the most urgent. This and other provisions that in practice grant controlling shareholders a call option on the free float, usually at book value, need to be crapped from the law. And that means, yes, going back to Congress.

In the meantime, it is important that the regulator holds a pro-active stance in making it harder to use the loopholes and increasing its cost.

Here, I would like to remember that the Brazilian regulator is not a judge. It has a legal mandate to be biased. In a free translation, the law states that one of the CVM`s attributions is to defend investors against abuses from controlling shareholders and fund managers – myself included! What I read from this clause is that the regulator must interpret the law, whenever possible, applicable and legal, in the investor`s favor.

3. Integrity of Financial Statements

This is an easy one. We have two main fronts here.

The first one is auditor firm rotation. I believe the CVM did a terrific job in resisting pressure to scrap the rotation. It upheld its 1999 decision – a visionary one, we must say – to implement mandatory audit firm rotation, and the initial impacts are positive. Many companies undertook adjustments to their accounts because of rotation, which clearly represent an improvement in the quality of reported earnings. Also, the CVM deserves credit for enforcing disclosure rules on non audit feeds, despite deep resistance from companies. The challenge here is to keep up the good work.

In terms of convergence to IFRS, though, we are at square one. A bill sits in Congress for many years now, stuck because of the sheer lack of political will, and of course because of lobbying from industry groups against mandatory disclosures for large private companies. All interestd in the capital market reform should pay attention to this issue, which will be discussed in the IBGC Congress in November.

4. Developing effective boards

This is another topic in which we have a long way to go. There are some reassuring movements on a voluntary basis. Companies are restructuring their boards and adding independent members. The IBGC has trained hundreds of individuals in its courses. Audit Committees are being structured and in 2006 we will be free of the weird oversight awarded to management on board candidates appointed by minority shareholders.

However – and always "however" – we have problems. Article 118 as changed in the 2001 reform allow for the legal use of puppet board memgers. And companies are happily using this provision, which completely maimes board effectiveness and accountability.

Worse still, we haven't been able to define and enforce Article 115, which prevents conflicts of interests. It is of the utmost importance that opinions and jurisprudence define conflict of interest in a way that truly fosters the duty of loyalty. This is not happening today.

Additionally, Brazil has a very poor history of holding managers and board members accountable. True, we've seen some landmark cases of punishment which are a very positive development. However, those are not yet common. We still watch in awe as clear perpetrators are acquitted based on acrobatic performances of highly paid lawyers, twisting and turning the law to prove that their clients committed nothing illegal, albeit clearly immoral. Principals on which our law was based are all but forgotten.

Some cases are worth mentioning. In a few, board members were acquitted despite frauds in their companies, alleging that their role was purely decorative of that of a

consultant. Others were acquitted alleging that they were “unaware” of an irregular related party contract amounting to hundreds of millions of dollars.

If board members keep getting away with murder in cases like these, we cannot possibly talk about effective boards. Board members MUST be held accountable to shareholders and to the regulator.

5. Improving quality, effectiveness and predictability of regulation

Again, we`ve seen improvements, but those are far from enough.

Quality is being hindered by bases such as the ones I’ve just mentioned. As long as enforcement follows the letter of the law and not its spirit, those acrobatic performances of lawyers will continue to be rewarded.

Effectiveness is also an area to be improved. We saw the results of the OECD research, which I found very enlightening. Despite Mr. Trindade’s explanation on the lag of collection of fines, I believe there’s something else going on . It is in fact hard to collect the most important fines, and we have to work on that.

Predictability is another area for improvement. The CVM has been working hard to improve predictability of its rulings and regulations, and that is good. However, predictability should not be the same as a monolithic interpretation of the law. Predictability is achieved by making the decision process clear to all participants. The law must be interpreted, with the bias mandated by law, in a predictive manner.

The other problem related to predictability is what I call the “illusion of protection”. Brazilian law has many guarantees to investors that look great on paper, but that in fact are not enforced. The issues of board responsibility, conflicts of interests and loopholes in tender offer rules are but a few examples. Investors feel protected with these rights, but when they really matter, they do not work.

I believe that disappointment with perceived protection is responsible for a large part of the negative sentiment of investors. Of course, investors should do their homework. But one should not expect investors to undertake a doctoral course in Brazilian capital market regulation to understand it and be able to price securities. The solution, again, in addition to legal reform, is a pro-active approach by the regulator in the enforcement and interpretation of the law.

I would add to this list the need to improve perception of enforcement and compliance. A country cannot prosper if one has the impression that some rules "stick", and thus are enforced, and others don't. If one believes that a particular rule is not enforceable and that "everybody does it", this belief contaminates the entire regulatory framework. Therefore, while I agree that the regulator must concentrate on the most relevant cases, it is important not to forget the others.

If a rule is useless or unenforceable, it should be crapped. It cannot be left there, void of relevance, otherwise it will increase the problem of "illusion of protection" and undermine faith in the effectiveness of the regulator.

6. Continuing regional cooperation

Since I've already spoken too much, I'll skip this last recommendation of the White Paper, simply mentioning that cooperation has been less than ideal. It would be interesting to see more exchanges among emerging and developed markets.

In conclusion, my point here is: reform is not over. In fact, if we sit back and congratulate ourselves on our successes, we risk losing momentum and getting back to square one.

I close suggesting as a topic for a forthcoming meeting how to keep that momentum and how to avoid the backlash we are currently experiencing from those that represent the status quo.

Thank you.