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White Paper Progress Report – Brazil

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Introduction

This report considers Brazil's progress in implementing the five priority issues set out in the Latin American White Paper on Corporate Governance: it reports on progress over the past three years, key developments, obstacles to progress and priorities for further improvement against each priority. When the White Paper was issued, major legal and regulatory reforms had recently been undertaken in Brazil, addressing several aspects of the issues discussed below. In addition, the past three years have been a period of voluntary corporate governance initiatives of companies, some undertaken through the mechanism of Bovespa's Novo Mercado and others negotiated and executed independently. Therefore, considering the generally improved quality of the current legal environment, one useful way to monitor the White Paper's implementation is to measure enforcement activity with respect to the recommendations below. Except when herein expressly cited, we believe that extensive, further legal reforms are not the priority at the current time. The priority must be on enforcement of existing legislation and speeding up judgement of current administrative procedures.

Issue 1. Taking Voting Rights Seriously.

White Paper Recommendation: Steps should be taken to facilitate shareholder participation in General Meetings and voting of shares. Institutional investors that in many cases have taken too passive a role should be encouraged to exercise their ownership rights in a more active and informed manner. If the legal framework allows shares with different voting rights, this needs to be fully justified and accompanied by commensurately stronger and more effective protection of minority shareholders.

- **Has there been progress on this issue over the past three years?**

Brazilian legislation does not adopt the one-share-one-vote principle. The 2001 corporate law reform established a maximum 1:1 ratio between common and preferred (non-voting) shares, instead of the 1:2 range previously permitted. This provision applies to new companies and to privately held companies going public, while existing companies were allowed to maintain the previous proportion of voting to preferred shares, including for new issuances.

A call for a general shareholders' meeting must be made at least 15 days prior to the meeting itself. Importantly, the recent legal reforms empower CVM to increase the number of days before a meeting to 30 if, upon the request of a shareholder or *sua sponte,* the CVM deems the agenda items particularly complex. The CVM can also suspend a shareholders meeting to request additional information or to provide an opinion in reference to a specific resolution on the agenda. Documents distributed to shareholders must be made available to the stock exchange and the CVM, to ensure adequate timely disclosure. Since this power was granted, the CVM has received 20 requests, resulting in 4 extension orders. In one case, the CVM, *"sponte propria"*, has recommended the extension of the notice period of a meeting in a matter deemed to be complex, and the recommendation was followed.

Preferred shareholders representing at least 10% of capital and holding their shares for a minimum of three months prior to a shareholder meeting, may elect or dismiss one member of the board by separate vote. For common shares, at least 15% of voting capital are needed. Controlling shareholders with 50% or more of the voting shares may appoint the same number of directors as are chosen by minority shareholders, plus one extra director[1]. In a number of cases, this right of minorities to appoint their representatives has been enforced by the CVM, which has sought to assure that board members elected by minorities do have full conditions to individually exercise their rights.

- **What have been the key developments?**

[1] Article 141, §4, of Law 6.404/76, as amended by Law 10.303/01.

In practice, all the companies that went public during 2004 and 2005 issued either exclusively common voting shares (listed on Novo Mercado), or issued preferred shares (listed on Level 2) with voting rights in the case of certain corporate operations and related party transactions, and that also benefit from at least 70% tag-along rights (i.e., the right to receive at least 70% of the price paid to the controlling shareholder in the case of a transfer of control). Although the characteristics of these new shares were largely the result of self-regulation (mainly through Novo Mercado), we can reasonably affirm that they have become necessary conditions for prospective listings in order for them to succeed. With respect to preferred shares, it can be inferred that the market recognizes that such shares are appropriate only if there are indeed commensurately stronger protections for non-voting shares, as provided by the rules of Level 2.

The Brazilian market has shown a sharp increase in the presence of individual investors (almost 30% of Brazil's daily trading volume as compared to 20% a few years ago[2]). The new primary and secondary offerings that took place in Brazil during 2004 and 2005 occurred, almost without exception, among companies from Level 2 and Novo Mercado that require higher corporate governance standards. Novo Mercado companies issue only common shares, while Level 2 companies may have preferred shares, provided that such shares have voting rights in the case of certain key corporate actions, and at least 70% tag- along rights. However, the IPOs are too recent to allow reliable statistics on the effects of individuals' participation increase.

In Brazil, securities markets and pension funds are regulated separately. Pension funds regulation traditionally has a prudential focus, whereas capital market rules reflect a disclosure regime approach. As to the pension funds, Resolution 3.121, issued in September, 2003 by the National Monetary Council, replacing previous Resolution 2829/01, stated maximum investment limits to pension funds' portfolios. The Resolution allows pension funds to invest a certain amount of their portfolios in variable income, ranging from 35%, in the case of companies listed in regular markets, to up to 50%, in the case of companies that participate in special corporate governance segments of Bovespa (Section 25). Changes made to the percentage limitation between Res. 2829 and 3121 were motivated by a desire to be more realistic, given the existing equity portfolios of key institutional investors and the (at that time) slower than expected growth in Novo Mercado listings. Investment in closely held companies are considered to be in variable income and, for that purpose, the Resolution also imposes different limits depending on the company's commitment to good corporate governance practices (Section 25). This same Resolution (Section 6) requires that pension funds must define an investment policy for their benefit plans, which may vary according to the kind of plan, as well as to adopt a Code of Ethics. Seeking enforcement of those new provisions, the Resolution also gave reinforced powers to the pension funds Fiscal Boards.

It is also worth remembering that in 2001 the Pensions Management Council issued Resolution nº1, requiring pension funds to send a report to their participants disclosing the general meetings of the companies in which they invested, and detailing decisions that involve related-party transactions (Section 1, Resolution MPAS/CGPC nº 01, December 19, 2001). In addition, the largest pension funds have voluntarily disclosed their policies as to the exercise of their voting rights and issued private codes of corporate governance to provide orientation to their representatives.

Similarly, mutual funds that invest in shares must disclose in their prospectuses their policies regarding exercise of voting rights in investee companies (Section 35, XII, Instruction 302/99, as amended). Each semester, fund managers must also forward to their quotaholders a report summarizing some basic mandatory information, among which is included the full wording of the votes cast in general meetings taking place in invested companies, a justification, written by the fund's manager, for such votes, or the reasons for its abstention or non-attendance, as the case may be (Section 68, Instruction 302/99, as amended). These rules do not require mutual funds to actively vote their shares, and many funds continue to take a generally passive approach. However, the policies and practices are now transparent to quotaholders, who can take them into account in choosing among investment vehicles.

[2] Source: Bovespa's Technical Reports.

In order to stimulate investment in private equity, the CVM issued the Instruction 391/03, concerning the creation and operation of private equity funds. Private equity funds may invest resources in public or closely-held companies, as long as they retain the right to participate in the company's decision-making process, with effective influence over its strategic policy and management.

Brazil also had important improvements in fiscal law (Laws 10.033/04 and 11.053/04) that reduced the income tax for capital markets operations, increased the monthly exemption limit for stock exchange trades and changed the tax regime applicable to investment funds. Moreover, since 2002, Emenda 37/2002 has eliminated the CPMF tax on stock exchange transactions. Such modifications are aimed at fostering long-term savings and their investment in capital markets.

As a result of its recent offering of shares listed on Novo Mercado, Lojas Renner became the first broadly-held company without a defined controlling shareholder. This is something of a new paradigm for a Brazilian company. So far, the company's shares have been well-received in the market, indicating a degree of confidence in the mix of voluntary and mandatory rules in force with respect to the company's governance. However, the experience of Renner management, directors and investors in the medium term may provide indications for the direction of future legal and regulatory reform efforts.

- **What have been the obstacles to progress?**

There were no legal reforms proposed during this period. The main challenge has been to enforce existing provisions. Once investigated and concluded with rulings, high-profile cases may set the best examples for influencing future corporate governance behaviour.

Changing the requirement that shareholders meetings be held at the companies' headquarters is sometimes proposed as a means to foster shareholder participation. In a large country such as Brazil, it may be too costly for shareholders to afford to attend meetings held in places far from more central cities, as the case may be. However, there is a consensus that companies with regional headquarters also attract local individual shareholders whose attendance at meetings could also be hampered should the meetings be moved to larger cities. Moreover, the fact that the company headquarters are broadly disclosed and generally stable explains its mandatory adoption, and provides minority shareholders a safe harbour against last-ditch manoeuvres from controlling shareholders.

In order to increase participation in general meetings – especially for annual meetings – some ideas have been suggested to make these more interesting and less formal events. One suggestion was to impose, as a mandatory item on the agenda, a presentation by the company to the shareholders, with the participation of the executives and directors. This could be a means to better explain the company to its shareholders before passing to the next items, such as financial statements approval and directors' elections.

General meetings, be they annual or extraordinary, are private situations involving a company and its shareholders, provided that the pertinent legal dispositions are complied with. Moreover, the relationship between shareholders and a company at general meetings should maintain the flexibility to be responsive to shareholder demand, rather than following a strict format that may not be appropriate in every circumstance. Therefore, such proposals are not appropriately addressed through regulation, but could be encouraged by self-regulation, for instance, in Corporate Governance Codes or in special segments listing rules.

- **What should the priorities for further improvement be?**

The CVM is working on a "Parecer de Orientação" comprising the main questions concerning general meetings, and stating its interpretation on themes that are commonly decided by the Board of Commissioners. Although this document does not represent either a new rule or a change in orientation, we think it could serve as an educative guide to the market, compiling the CVM's opinion on the most frequent cases.

Issue 2. Treating Shareholders Fairly during Changes in Corporate Control and De-listings.

White Paper Recommendation: The legal and regulatory framework must provide for clear and *ex ante* rules regarding how minority shareholders are to be treated when there is a change in corporate control. Improvements should also be made to ensure a fair, practical and predictable system for valuing the shares of minority investors in cases of de-listings or exercise of withdrawal rights.

- **Has there been progress on this issue over the past three years?**

The corporation law has a clear and well-tested rule for changes in corporate control and a corresponding modern regulation (Instruction 361/02). Together the law and the regulation set out how shareholders will be treated, require full disclosure by all parties and provide shareholders with reasonable time to decide whether to tender. Such norms have existed since 2001, when the corporate law reform restored the mandatory 80% tag-along right to common shareholders and special rules to protect minorities in the case of going-private transactions, such as de-listings.

In the case of de-listings, the law gives minority shareholders the economic value inherent in their shares, based on an independent appraisal. Instruction 361/02 sets out tender offer rules and states that a tender offer must be launched whenever a controlling shareholder, or a third party directly or indirectly linked to the controlling shareholder, acquires up to 1/3 of any class or type of the company's outstanding shares (cf. Sections 26 of Instruction CVM nº 361/01).

Also according to CVM rule 358/2002, the company must release a material fact sheet with information on the buyer and seller, the price, objective and purpose of the acquisition, the number and percentage of shares involved and conditions of the deal. CVM also requests information on shareholder agreements, the new company's intention with regards to listing, and an updated shareholder list.

Finally, Bovespa created in June 30, 2005, a "Tag-Along Index" (ITAG) that measures the performance of companies that voluntarily offer tag-along rights to their shareholders. This is an important step towards demonstrating the value of the Tag Along as a good corporate governance practice in itself. For instance, the new index will also highlight certain large companies that grant this right to their shareholders, despite not being listed in any special corporate governance segment.

- **What have been the key developments?**

In the three years since their enactment, the transfer of control rules has proven to be suitable for all corporate control transactions. So far Brazil has had 23 tag-along offerings triggered by transfer of control, and no problem with the application of new rules. However, those cases did not raise any serious doubts because they were transactions involving a defined controlling shareholder that sold his stake to an identified third party.

There are currently 56 companies listed in Bovespa, including many that are not required to do so as part of the Novo Mercado and Level 2 listing requirements, that voluntarily grant tag along rights to their shareholders (either common or preferred ones) in cases in which they are not obliged to do so by the law.

Several companies on the Bovespa have also de-listed in recent years, and by most accounts CVM regulations in this area have proven effective. In a number of cases shareholders were able to make use of its provisions to assert their rights to transparency and a fair price.

- **What have been the obstacles to progress?**

Corporate control transactions are becoming much more complex, financially significant and sophisticated. Although fitting the majority of the cases, current law may not be fully responsive to more sophisticated transactions and therefore may need to be updated. Moreover, when the amounts involved in a change of control are too large, or when the size of the entities involved is too big, it is reasonable to expect that the consideration agreed combines money with other assets, and that such consideration is not necessarily paid in cash, but over time, in instalments. In such cases, applying the fair price and equal treatment rule to protect minority investors may also be a problem. Complicated price transparency problems may also arise in indirect transfer of control, by means of operating holding companies, for instance. Somewhat more complex is the case of control blocks held together via a shareholders agreement, when some shareholders sell, while others keep and/or increase their participation. These types of problems are a common feature of jurisdictions that adopt tag-along rights systems.

Finally, change of control situations generally demand fast and reliable opinions that regulatory bodies find difficult to generate because of the technical and comprehensive nature of these activities.

- **What should the priorities for further improvement be?**

More study is clearly required of the appropriateness and adequacy of Brazilian legislation to address current sophisticated corporate transactions, as well as the best way to provide quick and reliable answers in those cases. The CVM is currently conducting a comparative study of how the issue is addressed in other important jurisdictions (USA, Canada, Mexico, Chile, Argentina, French, Italy, Spain, Australia, United Kingdom and Portugal), with the resources of a World Bank Loan Agreement. The results of this study, expected to be completed by the beginning of next year, will permit a comprehensive assessment of Brazilian legislation and, if appropriate, may provide the elements on which to base a proposal for legislative change.

Issue 3. Ensuring the Integrity of Financial Reporting and Improving the Disclosure of Related Party Transactions.

White Paper Recommendation: National accounting standards should be brought into compliance with International Financial Reporting Standards and the quality of the financial reporting process should be assessed with a view to eliminate conflicts of interest. The disclosure of related party transactions and potential conflicts of interest in such transactions should also be improved and supported by better information about corporate ownership and control structures.

- **Has there been progress on this issue over the past three years?**

Brazil has advanced significantly towards adoption of international accounting standards, pursuing the purpose of achieving full harmonization. Yet, there are impediments under Brazil's corporate law to full harmonization and, in order to overcome such obstacles CVM has advocated new legislation. After languishing in Congress for many years, the bill has made progress in the past six months, and has engaged the attention of relevant authorities, but its prospects for passage in the near future remain unclear.

- **What have been the key developments?**

The CVM has long been making efforts, to the extent permitted by law (when no legal reform is needed), to harmonize accounting standards applicable to public corporations with international standards and interpretations. This has been accomplished via CVM instructions or Brazilian Institute of Accountants (IBRACON) pronouncements endorsed by the CVM. Examples include: Disclosure of related party transactions (IAS 24); Consolidation of financial statements (IAS 27); Investment in associates – equity method (IAS 28); Employee benefits (IAS 19); Consolidation of special purpose entities (SIC 12); Property, plant and equipment (IAS 16) – revaluation (market value) of tangible fixed assets only; Statement of changes in stockholders' equity (IAS 1); Effects of changes in foreign exchange rates (IAS 21); Impairment

of assets (IAS 36) – in principle, similar – however, no detailed rules exist; Inventories (IAS 2); Provisions and contingent liabilities – in practice, similar to IAS 37.

- **What have been the obstacles to progress?**

Some important points of international accounting standards are being discussed and, therefore, the consensus towards their adoption is still pending. Besides that, achieving harmonization with international standards requires passing Projeto de Lei nº 3.471 (PL 3.471) that is currently in Congress. This bill is aimed at, among other things, eliminating some isolated existing barriers to full compliance with international standards in Brazil's corporate law.

One of the reasons why PL 3.741 has been sitting in Congress since 2000 is that it has faced, from its inception, quite strong lobbies. The main opposition relates to:

- Publication of financial statements. Public corporations must publish financial statements in major newspapers and in the local official gazette (Diário Oficial) where they are incorporated[3]. Some of the gazettes reportedly charge high prices that may hinder public listing. The official gazette opposes the suppression of current mandatory publication because it would adversely affect its profits.

- Interests of multinational companies, which are incorporated in Brazil as limited partnerships (sociedades limitadas), and which do not want to disclose their financial statements in Brazil[4]. The current lack of publication requirement for limitadas is seen as hindering fair competition. Indeed, large companies incorporated as limitadas, especially Brazilian subsidiaries of foreign groups, can have access to fairly detailed information from the listed Brazilian groups they compete with, while conversely their Brazilian counterparts have very limited information on them and other limitadas. On the other hand, critics of the proposed measure argue that interested parties, particularly creditors, credit bureaus and rating agencies, already have access to this information, which is of little use to the general public, and would introduce another layer of burdensome regulation, thereby increasing the "Brazil Cost". Moreover, many of these multinational companies are publicly held in their original countries and, therefore, their information would allegedly be available there.

- **What should the priorities for further improvement be?**

The main priority is passing the new legislation. After that, the effort will consist of framing, creating and financing the structures therein provided, such as the National Accounting Standards Board.

Issue 4. Developing Effective Boards of Directors.

White Paper Recommendation: Laws and practices reflect that all directors, individually and collectively, should act independently in the interest of the company and all of its shareholders. There should be greater specificity concerning the procedural steps for fulfilment of the director's duties of care and loyalty and an explicit ambition by boards to clearly define their work procedures as well as those of special board committees. Boards should also improve their ability to manage conflicts of interest and ensure compliance with laws and ethical standards.

[3] Companies may publish their financial statements in an abridged instead of a complete version, provided they post an electronic copy of the complete financial statements on their website (most listed companies already do so).

[4] Under PL 3.741, all companies or groups of companies, regardless of legal structure (including corporations (sociedades anônimas) and limited partnerships (sociedades limitadas) considered to be economically significant, i.e., with total revenues in excess of R$ 300m (equivalent to US$126 million) and total assets higher than R$ 240m (equivalent to US$100 million), would be required to publish audited annual financial statements.

- **Has there been progress on this issue over the past three years?**

Brazilian corporate law states that directors and officers owe their duties to the company, without regard to the group of shareholders who elected them. Such duties include care, diligence, loyalty and confidentiality. CVM Instruction 367/02 obliges directors and officers to confirm in writing that they do not hold a seat on the board of a competitor, nor have any conflicts of interest.

Additionally, since 2001, the Code of Corporate Governance Best Practices issued by the IBGC has a definition of independent director and also a recommendation addressing conflicts of interest situations. According to the IBGC's Code[5], an independent board member: "a) has no ties with the organization, with the possible exception of some shares of its capital; b) is not a controlling owner, nor a member of the controlling group, spouse, or relation up to the second degree of kinship or affinity to any party in the aforementioned group, or having any ties with organizations related to the controlling owner; c) is not a former employee or officer of the organization or any of its subsidiaries; d) is not directly or indirectly providing or buying company services and/or products; e) is not an employee or officer of any company supplying service and product; f) is not a spouse or relative up to the second degree of kinship or affinity to any company officer or manager; and g) receives no payment from the company other than his directors fees (dividends from any interest in the share capital of the company are not hereby restricted)". Chapter 6 of the IBGC's Code, "Conduct and Conflicts of Interest" affirms that a "conflict of interest exists when someone is not independent with regard to the subject at hand, and may influence or make decisions based on interests that differ from those of the corporation." Should a conflict of interest situation arise, the Code recommends that the person in question disclose, in due time, his/her conflict of interest or private interests, and provides that, if this does not occur, any other person may do it. Furthermore, the section also addresses related party transactions procedures and related board of directors' duties.

- **What have been the key developments?**

The third revision of IBGC Code in 2003 can be regarded a key development for the establishment of effective Boards of Directors in Brazil. Although the code is not mandatory for listed firms, it set higher standards that can work as guidelines for firms willing to improve their corporate governance practices. Specifically, the third revision of IBGC Code introduced new guidelines in order to:

- Improve board's ability to manage conflicts of interest;
- Encourage boards to clearly define their work procedures through the approval of an internal regulation of the Board of Directors;
- Give directions to boards in the aspects of directors' independence and compliance with ethical standards.

All these new guidelines are described in chapter 2 of the IBGC Code.

The rising number of listed companies in the past couple of years was followed by an increase of quality in Boards of Directors. The transition of from a closed company to a publicly-held firm enlarges the scope of a company's public activity and requires familiarity with more complex regulations and compliance rules. Therefore, in many cases, it was necessary to remove family members from direct influence over companies and to hire professionals prepared to satisfactorily address market demands, etc. The majority of newly-listed companies have appointed one or two independent directors – professionals that may have been selected by the controlling shareholder, but are otherwise unconnected with the controllers or management. Additionally, the activity of private equity and venture capital firms, as well as the initiatives of pension funds and institutional investors, have contributed to more active and qualified Boards.

It is increasingly common that Boards of Directors formally establish working procedures, generally articulated in an Internal Code (Regimento Interno) and by a Code of Ethics, with which all Directors must

[5] Third Revised and Expanded Version, chapter 2.12, p. 22.

abide. Accordingly, it is more common, in large companies, that specialized Committees assist the Board of Directors.

Although there's scarce data to demonstrate the improvement of Boards of Directors in Brazil during recent years, there's a strong feeling among market agents that this is happening. IBGC monthly debates are one of the places where this feeling is frequently expressed by market agents. The main aspects of boards' evolution in Brazil can be considered the following: increasing presence of independent directors (board composition), increasing adoption of board's committees, greater separation of CEO and Chairman positions, increasing approval of formal internal regulations for boards and their committees, increasing conformity of boards' size to the recommendation of governance codes, and increasing appointment of a Board's secretary. In recent and not yet released research conducted by IBGC with the 146 most important listed companies in Brazil, it was found that:

- 72% of the firms had different people in charge of the CEO and Chairman positions;
- 31% had board committees formalized and explicit on public data;
- 73% had their boards composed solely of external directors, with the exception of the CEO;
- 66% had boards with 5 to 9 members (as recommended by IBGC Code).

The Fiscal Board, a mandatory supervisory body of Brazilian public companies, has been more active in its functions than previously. Many factors may explain this greater strength: the diversity of its composition, after the possibility of proportional election that was granted to certain minority shareholders[6] who can appoint their representatives on the Board by means of separate election, without the participation of the controlling shareholders; the increased powers that were given to individual members of Fiscal Boards; the activism of institutions like the IBGC, which issued a model Internal Guide to Fiscal Boards; and the enforcement activity undertaken by regulatory authorities.

Finally, the number of courses designed to provide corporate governance training to directors, boards and family members has surged, not only in main business centres, but also in smaller cities. The Brazilian Institute of Corporate Governance - IBGC - has played an active role in this field. As a result, Brazil has formed a new, enhanced group of professionals, specialized to face corporate governance issues and to behave in real board situations.

- **What have been the obstacles to progress?**

The ownership structure of Brazilian listed companies is concentrated and this concentration is one of the factors that contribute to the lack of liquidity of Brazilian securities markets. Not only are the controlling shareholders concentrated, but also the other shareholders' stakes. Within this framework of companies with large defined shareholders, it is hard, and even of questionable utility, to enforce the proposed independence concept of the board member as someone who is not appointed by the controlling shareholders. Moreover, even supposing this is achieved, such a definition could still be considered improper, as long as the non-controlling stakes are also concentrated in Brazil, but the members they elect would be considered independent.

Defining independence in an environment of concentrated ownership is not an easy task, and quite different from the independence concept applicable for dispersed ownership companies. In situations of concentrated ownership, perhaps we should start by increasing awareness concerning board members' qualifications and professionalism. Having professional and qualified board members who are well prepared to perform their duties may be more useful than judging the independence of someone on the grounds of who was responsible for his election.

Considerable contention has arisen concerning the construction of §8 of Section 118 of Corporate Law and its effects over corporate governance, which states that, if a given matter is subject to a shareholders

[6] See Article 161, §4º of Law 6.404/76.

agreement, the vote cast by the board member must follow the shareholders agreement decision, or else the board member's vote may not be considered. Some would like to see this restriction lifted, considering it to be prejudicial in the sense that it could hinder directors' independence, because directors will consider themselves bound by dispositions set forth by shareholders agreements. They argue that directors did not execute such agreements – instead, the shareholders who elected them did – and for this reason the law should leave them free to vote as they wish.

However, others interpret the law to provide greater freedom for such board members to vote as they wish, and see no need for a change in the law. They suggest that all board members have the same duty to serve in the best interest of the company, no matter what shareholder group appointed them, and no matter whether a shareholder agreement exists. Further, considering that nowhere in the law is the board member forbidden to vote, in the case that such board member understands that the decision taken by the shareholders who signed a shareholders agreement in a previous meeting is illegal, or damages the interests of the company, he must vote against that previous decision, because voting against it would be the only means of preventing his own personal liability for the consequences of a bad decision for the company. In other words, saying that §8 of Section 118 obliged him to vote according to what was decided in a previous meeting is neither legal nor a correct excuse for a board member to safeguard his own liability. Because, on the one hand, the board member is not prohibited to vote and, on the other hand, he is required to serve in the best interests of the company, no matter the group who elected him.

- **What should the priorities for further improvement be?**

Remuneration packages are a key factor in directors and managers' performance. A balanced combination of fixed and variable payment structures may serve to best align the interests of management with those of the company and of the shareholders. Regulation could promote public discussion of the best ways of providing better disclosure of current remuneration packages, separately disclosing board and management remuneration, including fixed and variable compensation.

The CVM also intends to update the Parecer de Orientação nº 19 (stating the interpretation of the rules about constitution of Fiscal Boards) in order to reflect the legal reforms of 2001, as well as to enlarge its scope to address other common issues that are decided by the CVM's Board of Commissioners.

Issue 5. Improving the Quality, Effectiveness and Predictability of the Legal and Regulatory Framework.

White Paper Recommendation: Parallel to strengthening the capacity of rule-making and enforcement bodies, steps should also be taken to ensure that the framework supports effective use of private actions. Depending on the legal context, this may include the introduction of class action suits and mechanisms for alternative dispute resolution, such as private arbitration in the areas of company law and corporate governance.

- **Has there been progress on this issue over the past three years?**

At least at the administrative level, this was probably the issue on which the most progress is evident and most likely the one that may consume priorities for the next period. The 2001 reform also strengthened the CVM's enforcement powers and autonomy. In addition, during the depressed capital markets period (2001-2003), the CVM worked on reshaping and modernizing its regulatory framework and also to issue new rules after the corporate law reform. Therefore, since 2004, the main priority is to focus on enforcement of such rules. The 2001 reform also allowed companies to voluntarily introduce arbitration dispositions in their by-laws as an alternative means of dispute resolution.

- **What have been the key developments?**

The advisory activity of CVM[7] has surged in recent years. CVM staff is increasingly asked to provide advisory support to investors and to answer complaints related to market practices. There seems to be a trend that such advisory activity becomes as important as punitive actions taken by the CVM. We believe this to be an improvement for enforcement, especially because it enhances preventive measures, working as a means to avoid occurrence of future disputes and damage to the markets.

Focused enforcement has also produced a record number of punitive procedures and sanctions. When it is complete, as is currently the case, the CVM's Board of Commissioner's has been able to settle an average of 80 punitive procedures per year. Currently, the CVM has close to 100 pending procedures, which it intends to reduce to zero by 2007.

Regarding the judiciary, last year the government passed a constitutional amendment (EC 45/2004) that changed the Federal Constitution in order to enable 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 Courts. These include, among others, reforms to the civil procedure code to diminish the number and type of appeals allowed during litigation, reform of execution procedures, etc.

Additionally, since 2001, as part of the launching of the Novo Mercado, Bovespa created an Arbitration Chamber. Companies listed on Level 2 or the Novo Mercado must undertake to adhere to arbitration to resolve shareholder disputes. The Arbitration Chamber panel must give its decisions within six months. The Chamber consists of 33 arbitrators, which include former CVM presidents, lawyers, representatives from the brokerage industry, etc. Out of that list, both defendant and plaintiff choose each one arbitrator, and agree on a third panelist (should they fail to agree, the president of the Chamber chooses the third one). Although 25 companies have adopted arbitration clauses in their bylaws since adoption of the 2001 arbitration law, the Novo Mercado's Arbitration Chamber remains to be tested. However, the fact that it has not been used so far may be a signal that the corporate governance framework adopted by Level 2 and Novo Mercado companies might itself be efficient to prevent conflicts between shareholders.

The CVM also submits to public hearing any important regulation, before its issuance, according to article 8th, §3rd, of Law 6.385/76. The comments received from the public hearing usually give great contributions to the regulation process. In addition to resulting in better legal texts, the public debate has smoothed the process of adapting, complying and understanding the meaning of new norms. The fact that the market had the opportunity to get involved with the law before its enactment also facilitates the enforcement job of the CVM.

- **What have been the obstacles to progress?**

CVM cites two main constraints to enforcement. Although the CVM has adequate enforcement powers, it does not have direct access to information protected by the bank secrecy law, which is only granted through the judicial branch on a case-by-case basis or through the cooperation of the Central Bank. This situation often gives rise to difficulties when investigations, particularly those involving insider trading allegations, are being carried out. The law should permit the CVM to have direct access to data that is protected by bank secrecy as long as such a request can be justified as part of an ongoing investigation or is made at the request of foreign authorities as part of a Memorandum of Understanding (Convênio). Moreover, the capacity to use such powers effectively in developing enforcement actions is severely compromised by a lack of human and financial resources.

Although CVM generally has adequate and strong powers, there are some questions that can only be adequately addressed by means of access to courts. However, the Brazilian judicial system is quite slow and judges lack required specialization. Therefore, in practice, access to courts is not a reliable enforcement tool. The problem, however, is far more complicated because it is not only a matter of increasing the capacity of

[7] Based on articles 4th, IV, "b" and 13 of Law 6.385/76.

judges and creating specialized courts. A thorough judicial reform is needed, one that addresses the civil procedural system to change the system of appeals in order to shorten the duration of a process, to change the workings of the Superior Courts, to promote modernization and efficiency of the judiciary, and of court structures as a whole.

- **What should the priorities for further improvement be?**

Permitting CVM direct access to information currently shielded by the bank secrecy law is a priority and would enable Brazil to become a full co-operating member of the Multilateral Memorandum of Understanding (MMOU) of the International Organization of Securities Commissioners (IOSCO).

The staff of the CVM should be reinforced and new staff recruited, particularly in critical areas such as for inspections and more complex types of off-site surveillance. For instance, a department could be created specifically empowered to enforce rules.

Concerning the judiciary, the priority would be on the discussion and approval of legislation that is being analysed in Congress. Such legislation may put into practice the purposes and principles that inspired the approved constitutional amendment aimed at reforming the Judiciary.