Brazil

This report examines and makes recommendations aimed at strengthening equity market development in Brazil.

It was developed as part of the work of the OECD Latin American Corporate Governance Roundtable's Task Force on Equity Market Development, and served as a reference for Task Force discussions that took place in Argentina in June 2018. The report on Brazil and additional country reports on Argentina, Chile, Colombia, Mexico and Peru have drawn upon an OECD survey of company and investor perceptions in these six countries as well as additional research and interviews with market regulators, participants and other stakeholders. The six country chapters have also served as a reference for the 2019 OECD publication, "Equity Market Development in Latin America: Enhancing Access to Corporate Finance", which provides a more comparative perspective on developments across all six countries.

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1. Introduction

Summary

This report aims to highlight the findings of the survey conducted in Brazil with publicly and closely-held companies, institutional investors, and other stakeholders, in order to provide a better understanding of the obstacles to development of the Brazilian capital market, especially regarding the entry barriers faced by small and medium-sized enterprises (SMEs) to going public.

The survey comprised two parts. In the first one, on-line questionnaires were sent to several listed and non-listed companies incorporated in Brazil as well as to institutional investors. In the second part, individual interviews were held with listed and non-listed companies, institutional investors, private equity fund managers, a crowdfunding platform, and representatives of the Brazilian Securities and Exchange Commission (*Comissão de Valores Mobiliários* or "CVM").

A brief view of Brazilian capital market recent history

The history of the Brazilian capital market shows clearly marked cycles of expansion and contraction generally linked to the country's economic situation, as per the table below, which provides an overview of this situation in the last 5 years as compared to 10 and 15 years ago. The peak year for Brazilian Initial Public Offerings (IPOs), 2007, is also included for purposes of comparison[1]:

Table 1.1. Brazilian capital market development (2003; 2007; 2008; 2013-2017)

	Market Capitalisation	Average Daily Trading Value	Listed Firms	Initial Public Offerings		Secondary Offers	
	Amount (USD Million)	Amount (USD Thousands)	Total at year-end	Number	Amount (USD Million)	Number	Amount (USD Million)
2017	955,552.06	2,547,358.81	404	10	6,496.32	16	6,636.97
2016	761,619.10	2,183,247.66	434	1	211.90	9	2,945.61
2015	478,875.65	1,677,947.79	450	1	190.25	4	5,834.75
2014	843.894,20	2.626.245,24	455	1	168,56	1	6.243,25
2013	1.023.277,46	3.028.462,15	454	9	8.514,00	7	2.794,59
2008	592.789,82	2.208.944,88	439	4	4.567,87	8	16.605,28
2007	1.398.721,25	2.571.766,99	449	64	29.593,34	12	7.525,95
2003	234.219,06	234.104,00	410	0	0	7	1.992,17

The following paragraphs provide context for the above figures, briefly describing the evolution of Brazilian capital market since the beginning of the new Millennium.

The establishment of Novo Mercado

The problems faced by the Brazilian capital market have been highlighted in numerous local and international research[2]. As would be expected, some initiatives aiming to solve these problems and to develop the market took place over the years, of which is worth

mentioning the establishment of CVM in 1976 and the implementation of the current Brazilian corporate law in the same year. More recently, particular attention is drawn to the creation of the New Market (*Novo Mercado*), at the end of 2000, a special segment of the Brazilian stock exchange (*B3 – Brazil, Bolsa, Balcão* or "B3", then called "BOVESPA") which requires listed companies to comply with high standards of corporate governance.

The environment of the Brazilian capital markets during the end of the 1990s and the beginning of the 2000s was problematic and, at the very least, its prospects were not good either. The issuance of bonds and stocks during that period had never reached significant levels as a proportion of the country's GDP. Practically the only source of long-term financing for businesses in Brazil was the credit obtained from the Brazilian Development Bank (*Banco Nacional de Desenvolvimento Econômico e Social* or "BNDES"). Very few new companies applied to list their shares on the stock exchange. Due to the lack of liquidity and the low prices in the secondary market, the level of delistings was high; from July 1997 to the end of year 2000 the value of shares traded on the BOVESPA had declined by 46.8% and share prices had dropped 34.3%[3].

Given the grim outlook for the market, the exchange sought ways of reversing the process of decline that was looming at the time. For this purpose, a group of experienced professionals set out to identify key problems that were holding back the Brazilian market's development[4]. Briefly, they found that the factors that affected the market the most were related to shortcomings in corporate governance, the lack of sufficient guarantees, and protections for securities investors.

Solving most of these issues would require legislative changes and at the time there wasn't sufficient support in Congress for the new legislation needed. Therefore BOVESPA, acting as a private agent with the encouragement of capital market authorities, decided to draft its own listing rules for voluntary compliance in the hope that requiring enhanced corporate governance would make the Brazilian market more attractive for investors.

By the end of 2000, BOVESPA had brought in the Novo Mercado segment along with two more levels (Levels One and Two) between the former and the traditional listing segment. The two levels were to be steps for companies unable to meet the requirements of the most demanding listing segment in terms of corporate governance and transparency.

The years 2001 and 2002 were marked by several events that adversely affected the Brazilian capital market: Argentina's crisis deteriorated; the local energy crisis led to rationing; the 9/11 attacks at the World Trade Center; local and foreign investors' reaction to the probable election of a new left-leaning President who might change the course of Brazilian economic policy, which led to a severe weakening of the Brazilian real.

As a result, there was no significant progress in the period in the response to BOVESPA's new listing rules or the reform of Brazilian corporate law that had been enacted in 2001, but which had not addressed all the gaps detected by the exchange and the other market players involved in the efforts to improve the regulatory environment.

By the end of 2003, the effects of the aforementioned events had been diluted and the Brazilian market started to respond. There were no initial public offerings (IPOs) but seven secondary offerings were held to raise a total of USD 1,992 million. At that time, the Brazilian market's capitalisation was approximately USD 234,219 million, while the daily average trading value was USD 234.1 million. There were 410 companies listed on the exchange by the end of 2003, and the market concentration for the 10 largest companies by capitalisation and traded value was 49.8% and 53.3%, respectively.

The 2004-2007 historic boom

From 2004 to 2007, the capital market enjoyed an unprecedented boom in terms of Brazil's recent history: there were more than 150 share offerings on the Brazilian stock exchange. In addition to economic issues, such as the strong upswing in commodity prices in the period, which had a positive effect on the Brazilian economy as a whole, several factors contributed to this success, among them the key role of foreign investors in primary and secondary offerings carried out in the domestic market. In this respect, the data show that foreign investors accounted for around 70% of shares distributed from 2004 through 2006.[5]

The subprime crisis

Although Brazil was not one of the countries hardest hit by the 2008 subprime crisis, its effects did affect the economy. The Brazilian market's capitalisation ended 2007 at a record level of USD 1,398,721 million, nearly six times its 2003 level, but then plunged more than 55% to USD 592,790 million by the end of the following year. Nevertheless, the losses incurred in 2008 had practically been reversed by the end of 2009, when the market capitalisation reached USD 1,340,868 million.

Other data from 2008 provide a broader overview of the situation at the time: the average daily trading value was USD 2,909 million -- 13 times higher than in 2003; 23 companies had their listing cancelled and the year ended with a total of 439 companies listed on the exchange; there were four IPOs and eight secondary offerings that brought in USD 4,568 million and USD 16,605 million respectively.

The recent economic crisis and the beginning of the recovery

Since 2010, the Brazilian capital market has faced a continuous downward move. This trend was accentuated during the recent Brazilian economic crisis, the effects of which were especially felt in 2015 and 2016, when GDP fell 3.8% and 3.6% respectively, the worst fall in 120 years.

As might be expected, the effects of this serious crisis hit the Brazilian capital market head on. In 2014, 2015 and 2016, there were only 3 IPOs and 14 secondary offerings that raised total volumes of USD 571 million and USD 15,024 million respectively. During the period, 38 companies were delisted and by the end of 2016, there were 434 listed companies, which was below 2008's number. In 2015, the Brazilian market capitalisation reached US $ 478,876 million, showing a fall of more than 70% compared to 2010, which had reached the highest market valuation ever. By the end of 2016, the 10 largest domestic companies' market concentration by capitalisation had risen to 54.9% while concentration by traded value fell to 40.2%.

The abovementioned numbers clearly show the scale and severity of the crisis that has affected Brazil in the recent period. In an attempt to curb these effects, there were a number of economic measures and certain key structural reforms were approved by Congress, while there was a more coordinated approach in economic, fiscal and monetary policies. As a result, there was the beginning of a turnaround of the economic recession and by the end of 2017, Brazilian GDP had grown 1.0% after the negative variations of the previous two years.

This upturn was also felt in the capital market. By the end of 2017, market capitalisation had reached USD 955,552 million, to show 26% growth against 2016. The year's 10 IPOs and 16 secondary offerings raised a total of USD 6,496 million and USD 6,637 million respectively. On the other hand, 45 companies had their exchange listings cancelled, so by

the end of the year there were only 404 listed companies. Some reduction in market concentration of the ten largest companies was also apparent, with their market capitalisation dropping to 52.5% and even more sharply in terms of traded value, which fell to 38.67%, indicating that a wider range of listed companies were being actively traded.

Information on the Brazilian capital market's current situation

Ownership concentration

Although the Brazilian equity market has been through boom and bust cycles in recent years, as briefly mentioned above, some of its characteristics have remained more or less constant over the years.

One of the key indicators that distinguishes Brazil from other markets in some developed countries is the continued high level of ownership concentration. However, although most of the Brazilian publicly-held companies still have a controlling shareholder, it is already possible to view the beginning of a switch to a more dispersed ownership structure, at least on Novo Mercado.

For example, a recent study showed that 79% of the companies surveyed had majority or shared control in 2017[6]. The same report also showed that 30% of Novo Mercado companies had dispersed control against only 16% of those in the traditional listing segment. None of the companies listed in the intermediate segments (Levels One and Two) had dispersed control.

Reliance of companies on capital market financing

The capital market in Brazil has generally played a secondary role as a funding mechanism for corporate investment needs.

Even after 2003, when the institutional reforms and economic conditions, as described in the previous section, allowed the equity market to start recovering some dynamism, retained earnings continued to be the main source of medium and long-term funds. According to estimates[7], in 2004, retained profits accounted for 65% of the total funding destined to investment. Such number has been reduced since then, but remained at the level of 37%, in 2014 (before the severe crisis that hit the Brazilian economy from 2014 to 2016) and 39%, in 2017.

Bank credit isn't generally considered as a source to finance investments, due to the concentration of the market in very short maturities[8]. The exception has been the credit provided by the BNDES, the national development bank, with an important part of its volumes lent at subsidised interest rates. BNDES had its balance sheet greatly expanded in the period after the international financial crisis, in 2008. In 2016, with an important shift in government policy and due to severe fiscal restrictions, that trend was reversed: BNDES credit dropped from 18.3% of the gross fixed capital formation in 2009, to just 5.5% of the same investment figure in 2016[9].

Subsidies in most BNDES loans have all but been eliminated and that has opened some room for the capital markets. Volumes raised through capital markets instruments in 2017 were 59% higher than in 2016 (USD 56,1 billion compared to USD 35,3 billion), the highest amount since 2010[10].

The Brazilian banks were severely hit by default rates in corporate credit since the beginning of the 2014-2016 crisis, combined with the broad corruption investigations, that

have affected entire industries. Their behaviour since then has been very selective, with low risk appetite being perceived. Besides that, the most important demand side of the corporate credit market – the Brazilian large sized companies – is finding a viable alternative in the capital market investors.

With the sharp fall in the basic interest rate, from 14.25% in August 2016 to 6.50% in April 2018, investors are now looking for yields that they used to get from government bonds, and that shift has caused demand for corporate bonds to increase, reducing the cost for issuers. The financial conglomerates, with relevant presence in the credit market and in the investment banking side of the business as well, are leading market offerings of debt for their large corporate clients, with more competitive conditions nowadays than most credit operations.

Even the equity market, as already mentioned, started to recover, with 10 IPOs and 16 follow-on equity offerings in 2017, accounting for approximately 20% of the total raised in the capital market[11].

Listed companies' economic sectors

In relation to listed companies in each sector of the economy, the same 2017 study found 35% in consumer goods; 17% finance; 16% industrial goods; 13% public utilities; 8% basic materials; 5% healthcare; 3% oil, gas and biofuels; 2% information technology; and 1% telecommunications.

Listed companies size

Another important aspect of the Brazilian market worth mentioning is the fact that, in general, there are very few small or medium-sized companies listed.

With the reforms made in the beginning of the years 2000, there is a general perception in Brazil that the domestic IPO market is functional and reasonably efficient, provided there are adequate economic conditions. But that is true only for companies of a certain size, one which allows their equity offerings to reach at least USD 300 to USD 400 million. For larger companies, it is possible to go public in the domestic market, generally without the need to cross list in a foreign exchange to attract foreign capital.[12]

Small and medium-sized companies have been reluctant to access the Brazilian capital market and, as a matter of fact, the capital market has not been receptive to that type of issuer either, which has not gone unnoticed by policymakers over the years.

On the one hand, the stock exchange itself has created an entry-level market to facilitate listing for small and medium-sized companies (*Bovespa Mais*), in which newly listed companies are allowed to wait up to seven years before holding an IPO. The intention here is to allow listed companies to access the capital market gradually and smoothly by initially focusing on the listing procedure alone and only afterwards, when they feel they are ready, making additional efforts to obtain funding from the investing public. To date, however, fewer than 20 companies have been listed on Bovespa Mais, only two of them having raised capital through a public offering of shares.

On the other hand, as will be described in more detail in section 4, several market participants together with the Brazilian government set in 2012 to diagnose the reasons for the low level of capital market access by SMEs. As a result of this study, some legislative and regulatory measures were introduced, but beneficial effects of these measures have yet to be detected, in part due to the severe economic crisis of the recent period.

2. Listed and non-listed companies

After the sending of the questionnaires to several listed and non-listed companies incorporated in Brazil, a total of 30 responses to the survey were received, of which: (i) 21 responses from companies listed on the main market of the Brazilian stock exchange B3; (ii) one response from a company recently listed on the US stock exchange NASDAQ; (iii) five responses from companies listed on B3's access market ("*Bovespa Mais*"); and (iii) three responses from non-listed companies.

Further to the responses received, individual interviews were also conducted with five companies, of which three are listed on the main market and two in B3's access market. From the list of companies listed on the main market, one is a state-owned enterprise and the other two have a dispersed investors' base. Both companies listed on *Bovespa Mais* are privately controlled, one by a sole shareholder and the other is a family-controlled enterprise.

The sample of the survey comprises a universe of companies whose size, capitalisation and corporate maturity are quite diverse across the sample. For methodological purposes, the option taken was to separate the analysis of the responses received from companies listed on the main markets of Brazil's and foreign stock exchanges (B3 and NASDAQ) from the analysis of the responses from companies listed on the access market of Brazil's stock exchanges (*Bovespa Mais*), considering the quite different situations of those two groups. Furthermore, the responses from closely-held companies were also analysed separately.

To better interpret the responses to the questionnaires, two important considerations are required. On the one hand, it was observed that the companies listed on *Bovespa Mais* that responded to the survey have not made any public offering of securities yet, although they are listed and comply with the regulatory requirements for that condition.

On the other, it was also observed that the respondents in each case were quite different: for companies in the access market, the participants who provided the responses were, as a rule, their founders and/or entrepreneurs, whereas, for the publicly-listed companies in the main markets, the responses were almost exclusively provided by the investor relations areas.

These distinctions may help to explain certain important differences in perception between the two groups, especially in regard to the cost-benefit relationship of the stock exchange's listing, as it will be better examined below.

Listed companies

Companies listed on main markets

As mentioned above, the survey obtained responses from 22 companies listed on Brazil's and foreign main markets. This is a quite small sample considering that at the end of 2017 the Brazilian stock exchange had 343 listed companies, and cannot be considered statistically representative. The sample may be considered limited even if only the companies most actively traded on the Brazilian stock exchange are considered – 96

companies[13] -, since this represents only 23% of this universe. However, the intention in undertaking the survey was not to reach statistically significant findings, but rather to provide some relevant insights into company (and institutional investor) perspectives.

Among the respondents in the group, 57% are only listed on the Brazilian stock exchange, whereas 29% also have American Depositary Receipts ("ADR") traded on the New York Stock Exchange ("NYSE"), for which reason, therefore, they are registered with the Securities and Exchange Commission of the United States ("SEC") as well. Two other companies in the sample (9.5%) are registered with SEC, because they have their primary listing on US exchanges[14].That percentage (38.5%) does not reflect the universe of Brazilian listed companies, considering that only 7.6%, 26 companies have ADRs traded on US stock exchanges.

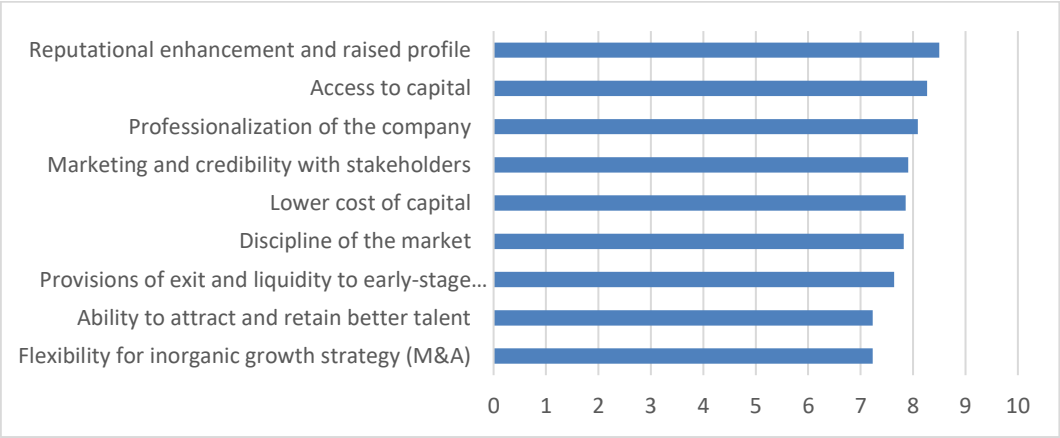
Concerning the ownership concentration, 30% of the companies in the sample have their control dispersed among shareholders in the market, whereas the further 70% has a defined control. Three of them are state-controlled (12.5%) and one is family-controlled (4%). Half of the companies are part of corporate groups, 55% of which in the position of subsidiaries and the remainder as parent companies.

Benefits and costs of being listed

In general, the group of publicly-held companies listed on the main market rated as moderately significant the benefits of being a publicly-listed company. The common perception of this group was that the advantages of being listed exceed the costs and even the risks resulting from this position.

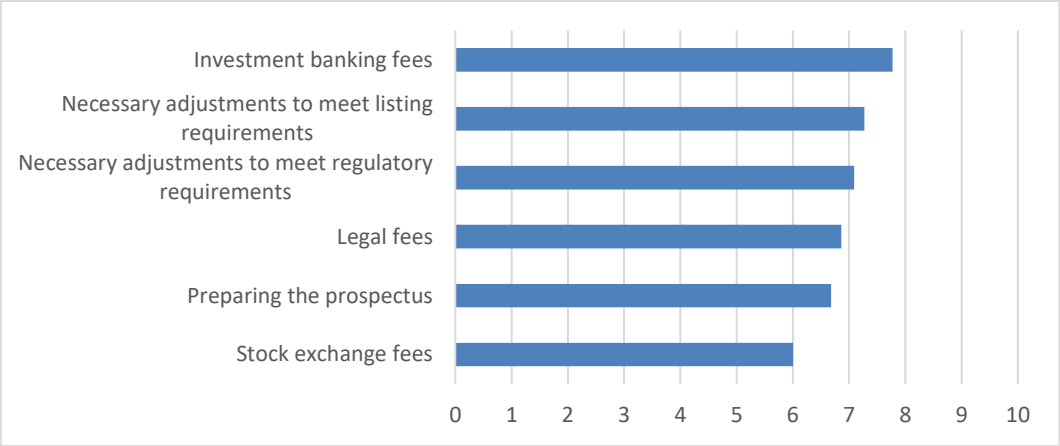
More specifically, the most significant benefits were considered to be such items as reputational and prestige enhancement vis-à-vis the market, access to capital and the company's professionalisation, closely followed by others, such as the company's higher credibility, lower capital cost and discipline of the market. Other items that were also considered moderately significant were the possibility of securing the exit of shareholders, the ability to attract and retain better talent and higher flexibility for M&A transactions. In his individual comments, a participant mentioned as benefits of being listed the greater transparency in the decision-making process and a better balance between the controlling shareholder and the stakeholders in general, whereas another mentioned the advantages of relying on market contributions to improve the company's strategies and performance.

Figure 2.1. Benefits of being a listed company (0-10 scale)



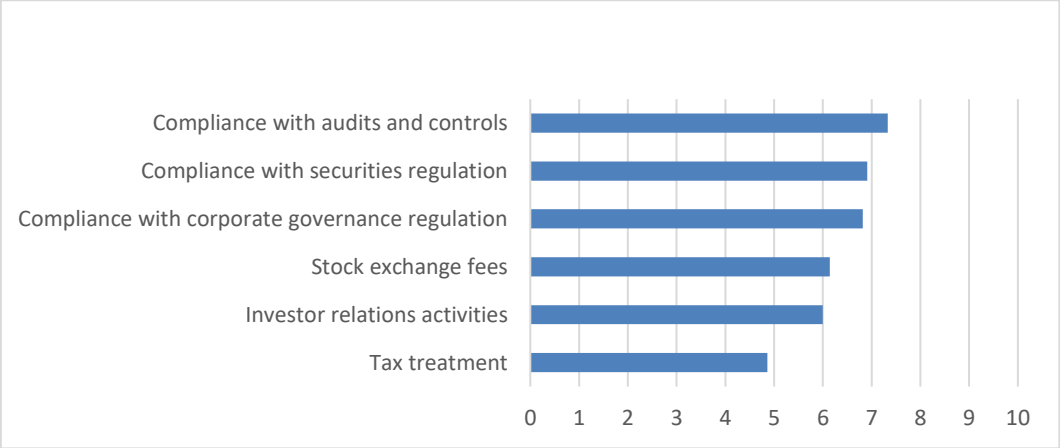
The costs related to the IPO process received average ratings that were discreetly (10%) lower than the benefits. Investment banking fees where highlighted as the most important costs, followed by necessary adjustments to meet listing and regulatory requirements, legal fees, the costs of preparing the prospectus and stock exchange fees. Two participants mentioned that the costs are, as a rule, increasing and increasingly prohibitive, and with respect to companies that are listed in the US, that the Sarbanes-Oxley Act (SOX) is particularly cumbersome and results in associated costs. On the other hand, two companies minimised the significance of the listing process costs, because by and large they would bring significant benefits to their corporate governance, and the work required for the IPO process, to a great extent, might be internally conducted.

Figure 2.2.Costs related to the IPO process (0-10 scale)



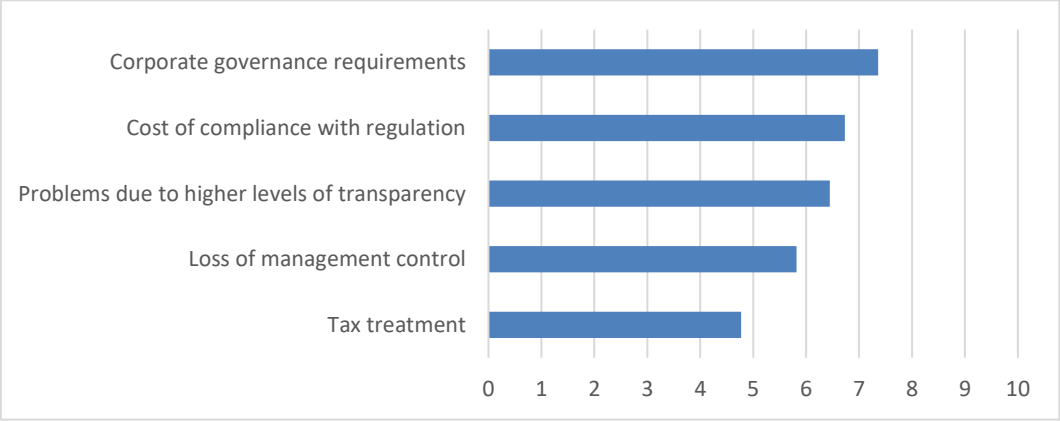
Considering the listing maintenance costs, in turn, the group considered this set of costs moderately less significant (20%), on average, than the benefits of being listed, and rated as relatively significant those costs related to compliance with audits and controls, with corporate governance and other regulatory requirements, followed by stock exchange fees and expenses for investor relations.

Figure 2.3.Listing maintenance costs (0-10 scale)



Finally, in terms of risks and consequences of being a publicly-listed company, the group assigned an around 20% lower significance on average compared to that assigned to the benefits, having considered relatively significant issues such as corporate governance requirements, cost of compliance with the regulation, problems due to higher level of transparency, and risk of losing management control.

Figure 2.4. Risks and consequences of being a listed company (0-10 scale)



When asked what are the main obstacles preventing access to the equity market, respondents highlighted excessive bureaucracy and regulation, investment banking fees and ongoing listing costs. One participant mentioned the current shareholders' fear of equity dilution.

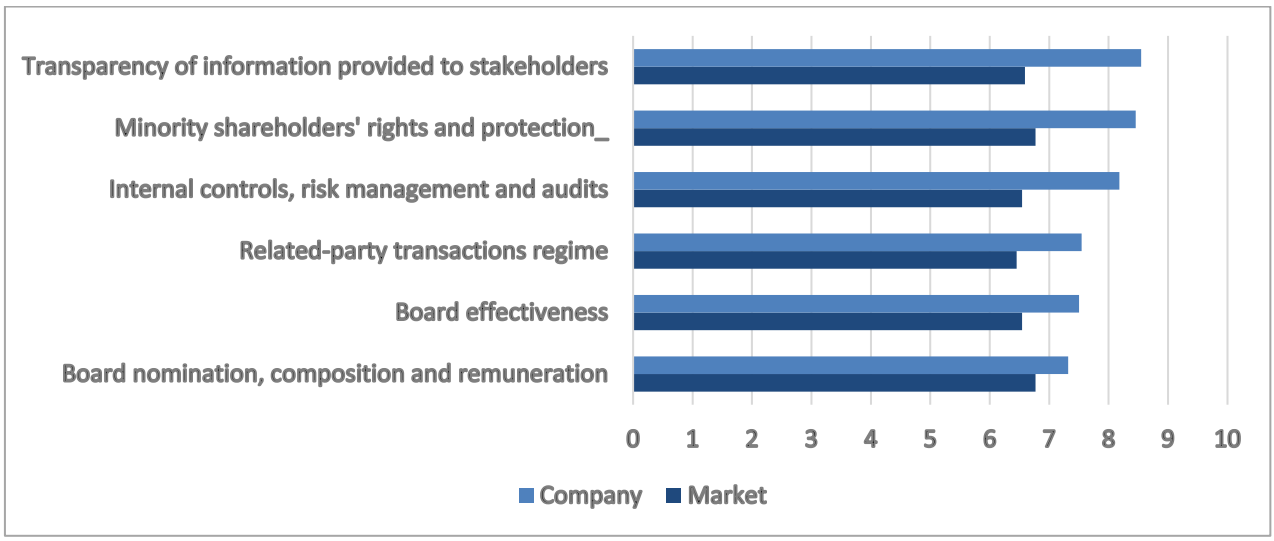
Corporate governance practices at firm and market level

The companies in the group rated the level of maturity of their own governance structures and practices in a more positive manner than the ongoing practices in the market in general.

Their own practices were classified with a fairly high rating. The better rated attributes were the transparency of the financial and non-financial information provided to the market, the protection of minority shareholders' rights, their internal controls, risk management mechanisms and audits. In addition, the company's treatment of related-party transactions, the effectiveness and ongoing practices for nomination and composition of the Board of Directors were fairly well rated.

On the other hand, the group considered as moderate only, on average, the level of commitment to the good corporate governance practices of the other companies listed on the Brazilian stock exchange market. In this field, the better rated attributes were the board composition and nomination, as well as the protection of minority shareholders' rights.

Figure 2.5. Corporate governance maturity (0-10 scale)



In terms of recommendations to regulators to facilitate companies' access to the local capital market, the comments emphasised the need of simplification and elimination of rules and bureaucracy for smaller companies.

Companies listed on the BOVESPA Mais

Five companies listed on the Brazilian stock exchange access market responded to the survey. This sample represents around 30% of the registered companies in that segment.

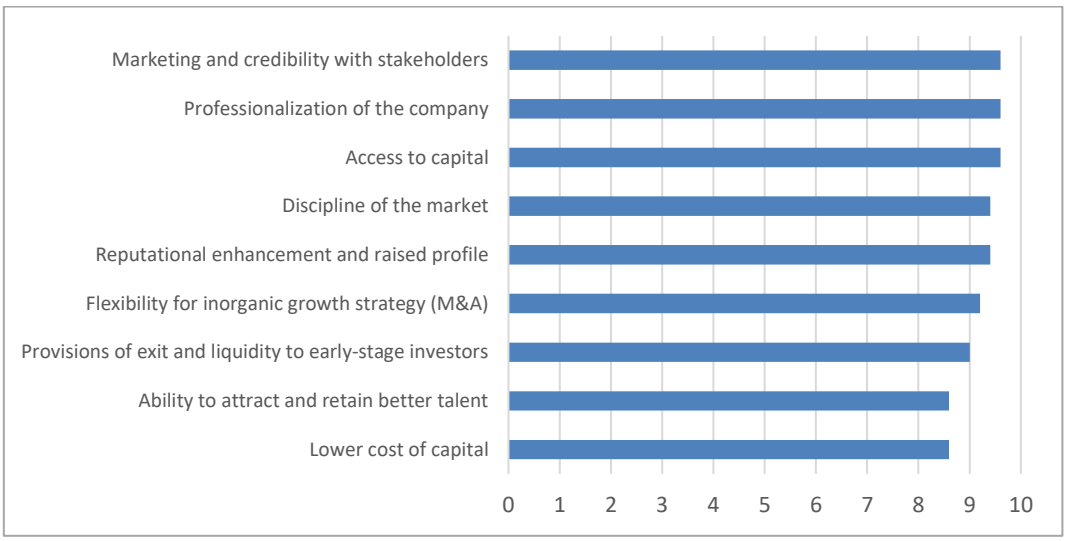
80% of the companies have a controlling shareholder with majority equity capital, whereas one of them is family-controlled. 60% of the sample holds private equity funds with an interest higher than 5% in their capital. Only one company participates in a corporate group, in the position of a parent company.

Benefits and costs of being listed

The *BOVESPA Mais* group was unanimous in the consideration that the benefits of being a listed company are highly significant and exceed the costs and even the risks associated to that condition.

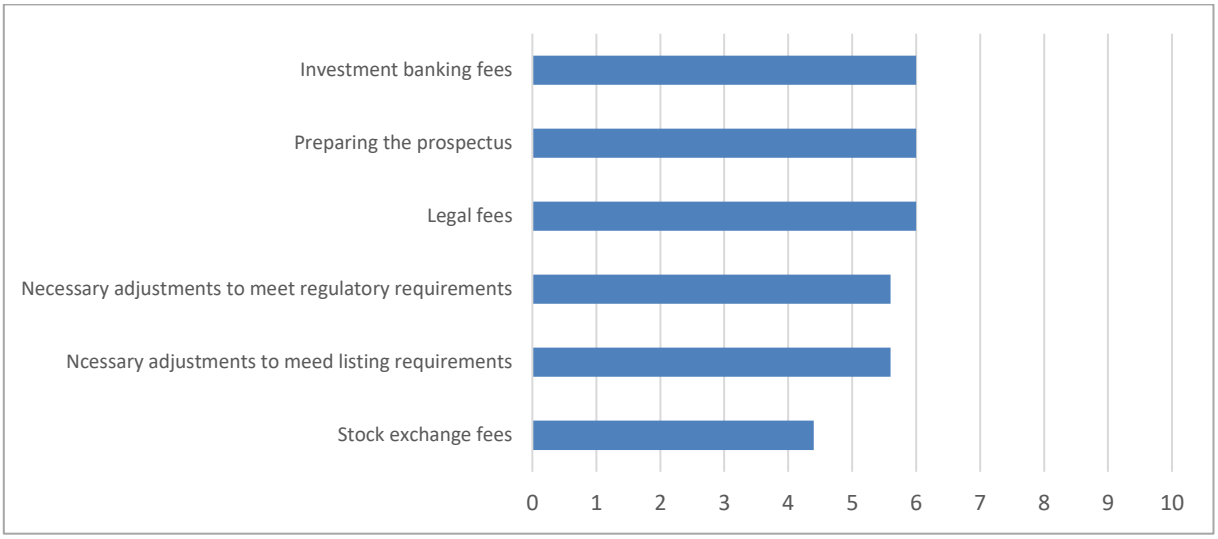
As to the advantages of being listed, the most significant items were marketing and credibility with shareholders, professionalisation of the company and access to capital, very closely followed by others, such as discipline of the market, reputational enhancement, higher flexibility for M&A transactions, the possibility of securing the exit of shareholders, the ability to attract and retain better talent and lower cost of capital. Concerning this issue, a participant mentioned that being listed brings "benefits and freedom" to the companies in many respects, especially to SMEs.

Figure 2.6. BOVESPA Mais benefits of being a listed company (0-10 scale)



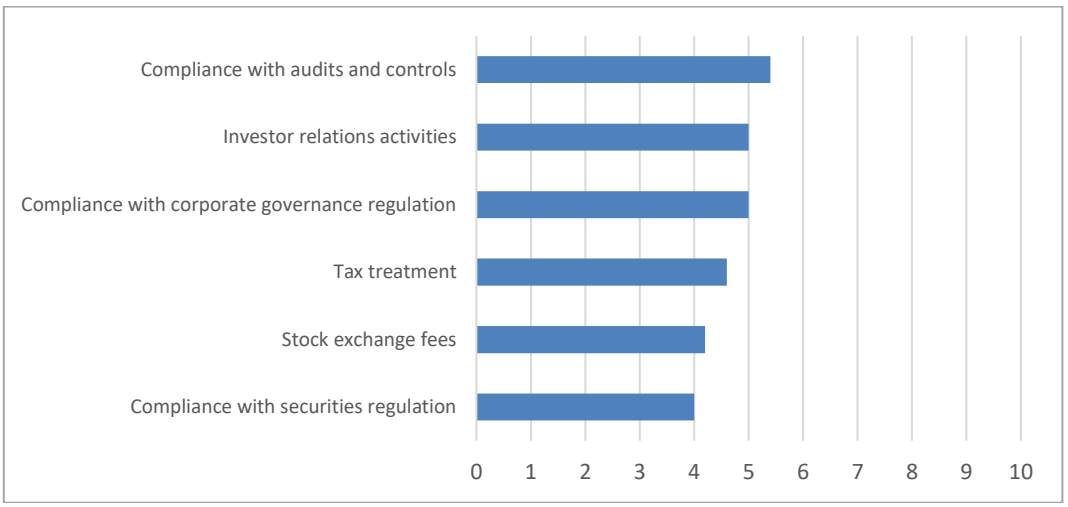
Costs related to the IPO process were on average rated with a significance level 40% lower than the benefits. Investment banking, costs of preparing the prospectus and legal fees were highlighted as the most significant costs, followed by necessary adjustments to meet listing and regulatory requirements.

Figure 2.7. BOVESPA Mais perceptions: Costs related to the IPO process (0-10 scale)



Concerning the listing maintenance costs, in turn, the group considered this set of costs 50% less significant, on average, than the benefits of being listed, and classified as relatively significant those related to compliance with audits and controls, expenses with investor relations and corporate governance requirements.

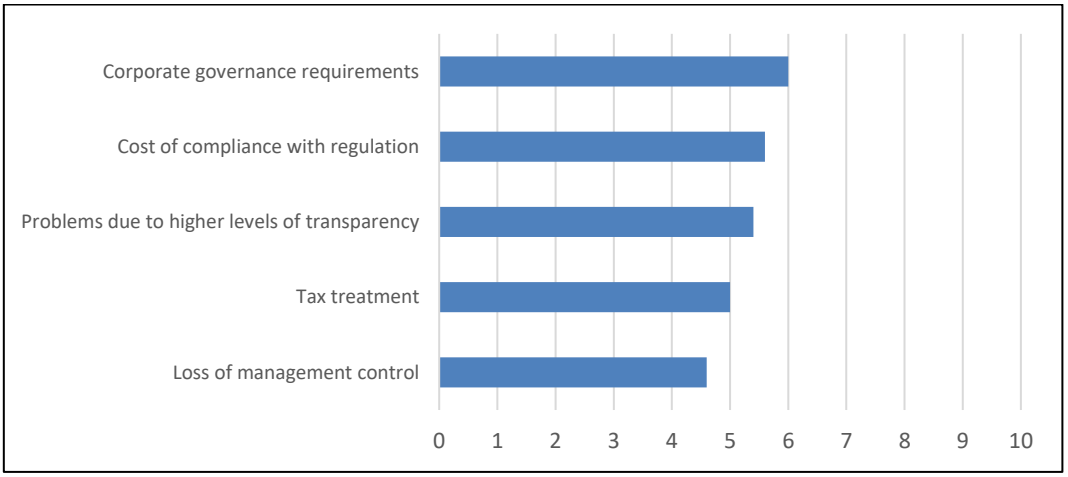
Figure 2.8. BOVESPA Mais listing maintenance costs (0-10 scale)



As mentioned above, the group of companies listed on *BOVESPA Mais* that responded to the survey has not made any public offering of securities yet. In this regard, the possibility that their perception concerning IPO costs has somehow been influenced by the absence of that experience should not be overlooked. Despite that possibility, the fact that their rating of the cost-benefit of the listing maintenance was quite positive corroborates, on the other hand, their relatively positive outlook regarding IPO costs. On this matter, a participant commented that the listing and maintenance costs would, in fact, represent investments to the company.

Finally, concerning the risks and consequences of being a publicly-listed company, the group assigned a significance similar to levels it had assigned to the expenses with listing maintenance, and rated as relatively significant the following aspects: corporate governance requirements, cost of compliance with regulation, problems due to higher levels of transparency and tax treatment[15].

Figure 2.9. Bovespa Mais risks and consequences of being a listed company (0-10 scale)



In regard to the question on "*what, in your experience, are the main obstacles preventing access to the equity capital market*", a participant considered that the major obstacle is the lack of information, preparation and dedication by the entrepreneurs in regard to the issue of access to the capital market by means of listing on the stock exchange.

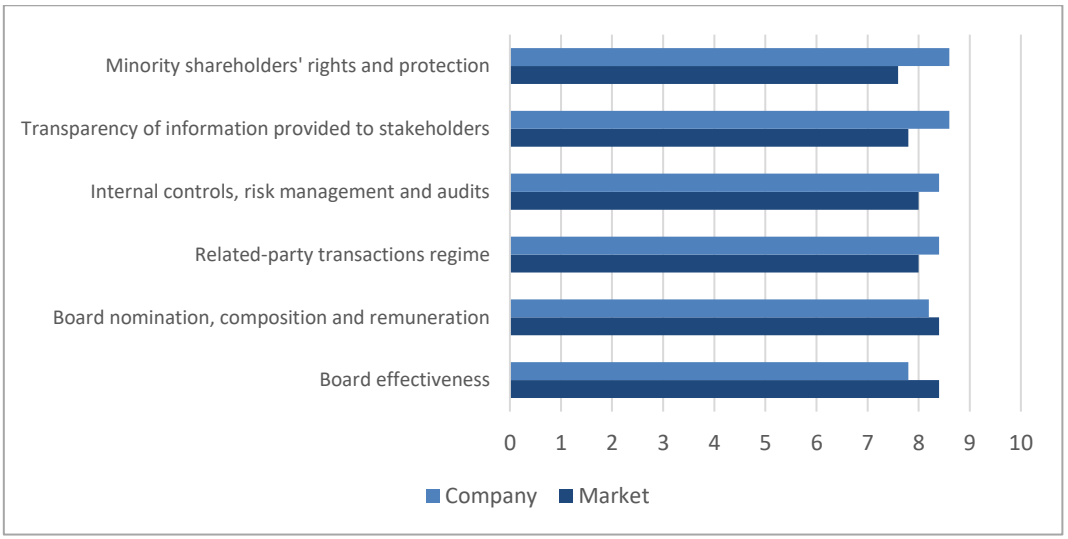
Corporate governance practices at firm and market level

When they rated the maturity of their governance structures and practices, *BOVESPA Mais* listed companies rated themselves at a level similar to the level they had assigned to practices in the market in general.

On the one hand, the companies classified with a fairly high rating their level of commitment to good corporate governance practices; the better rated attributes were the following: protection of minority shareholders' rights and transparency and quality of the financial and non-financial information provided to the market. Additionally, their treatment of related-party transactions and internal controls and risk management mechanisms, as well as the practices for nomination, composition and effectiveness of the Board of Directors were fairly well rated.

On the other, in addressing the practices of other listed companies in the market, surveyed listed companies classified on average their practices at a similar level of adjustment, i.e., fairly high. The respondents considered other listed companies' practices associated to the Board of Directors as slightly better than theirs, whereas they classified aspects associated to protection of minority shareholders' rights, transparency, related-party transactions, internal controls and risk management as inferior to their own.

Figure 2.10. BOVESPA Mais Corporate Governance maturity (1-10 scale)



In terms of recommendations to regulators to facilitate companies' access to the local capital market, one respondent suggested the creation of a team by regulatory or self-regulatory bodies specialised in clarifying, informing and motivating companies to seek to go public; he also suggested that the cases of success should be well publicised in order to "*show everybody that the capital market is for all companies and not for some companies only*". This issue was also highlighted by an investor personally interviewed for the survey for whom Brazil lacks a culture of encouragement of, and praise for, local entrepreneurs and business owners.

Non-listed companies

Although the questionnaires have been sent to several non-listed companies that have already been exposed to the going-public matter, considering that they have been contacted by the exchange's prospection team over the past years, only three responded to the questionnaire, of which one operates in the manufacturing sector and the others operate in different sectors of the economy.

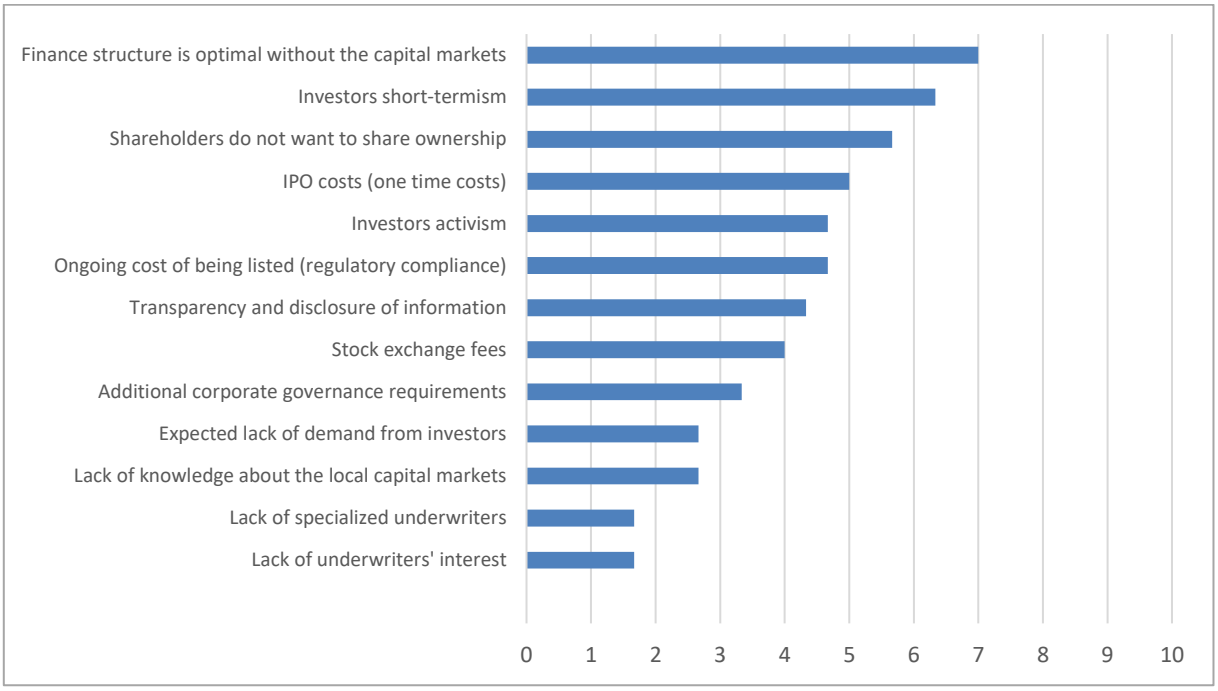
All of them are closely held by a controlling shareholder, whereas one is a family-controlled company and the other two are investees by private equity funds holding a more than 5% interest in their capital. Only one of the respondents is a parent company in a corporate group.

Pros and Cons of going public

Concerning the factors considered impediments to going public, the item with the highest rating, but that was only considered as moderately significant, was the lack of need for new capital, given the appropriate capital structure of the respondents. Other obstacles mentioned were the investors' short termism, the shareholders' lack of willingness to share the ownership with others, and the costs related to the IPO process.

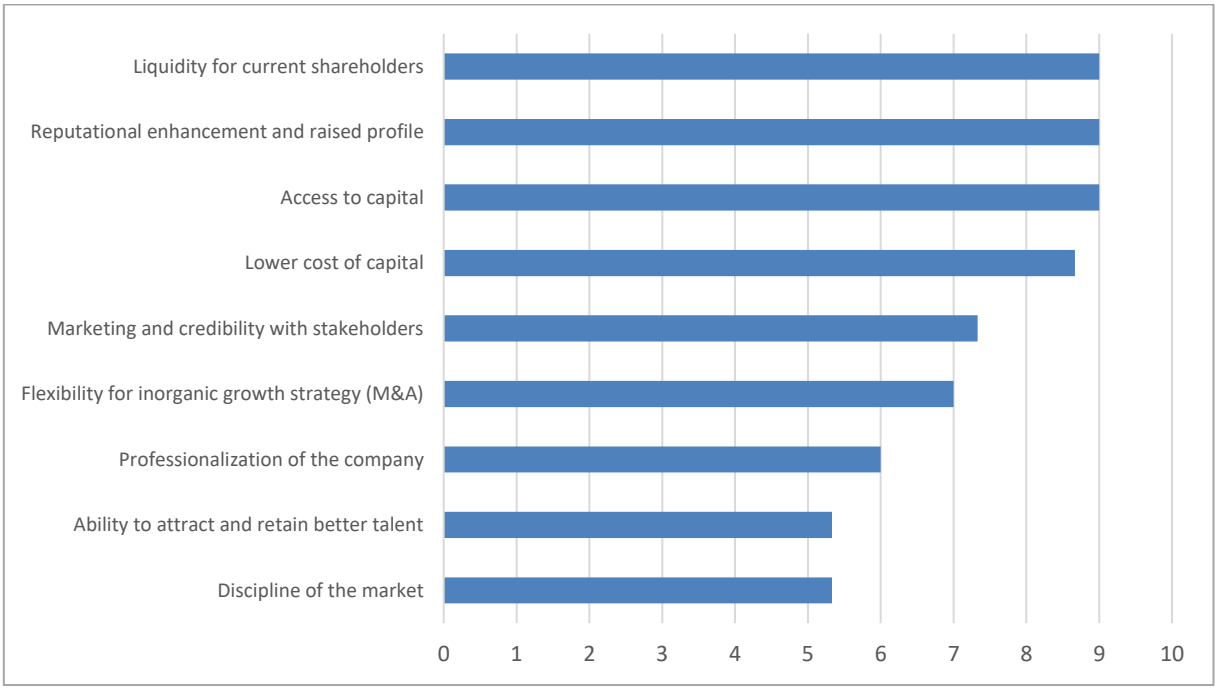
Difficulties knowingly faced by SMEs that go to the marketplace, such as the lack of intermediaries interested or specialised in leading small offerings and the lack of investors' demand for less liquid stocks, were considered non-significant by the group of respondents. Considering that this result contradicts the prevailing opinions among market players and the impressions obtained through the interviews, it may indicate that such companies have not gone to the marketplace yet to test the interest of intermediaries and investors.

Figure 2.11. : Non-listed companies: relative importance of elements for not going public (0-10 scale)



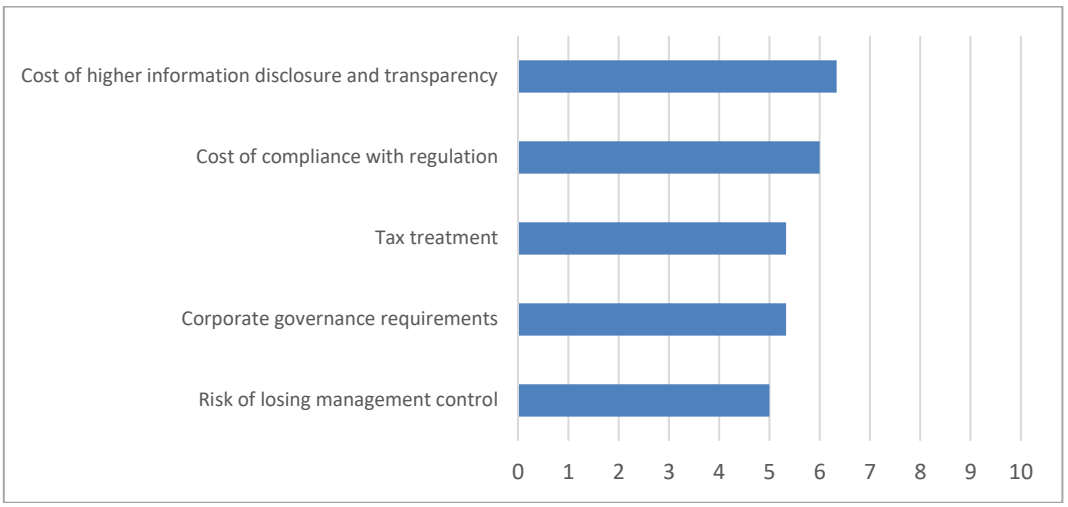
Concerning the potential benefits of going public, the group assigned higher ratings than for the impediments for several elements. These higher ratings were provided with respect to the liquidity that would be offered to the current shareholders, enhancement of the company's profile and reputation, the access to capital and lower cost of capital. This group also considered beneficial the marketing and credibility with stakeholders and flexibility to conduct merger and acquisition transactions by using their own-issued stock as currency. Variables such as company's professionalisation, ability to attract and retain better talent and market discipline were rated as moderately significant.

Figure 2.12. Non-listed companies: potential benefits of going public (0-10 scale)



As to the costs and potential risks associated to the condition of being a listed company, this group assigned to these factors a significance 25% lower on average than the benefits resulting from being a listed company, and rated as moderately significant the risks of higher transparency and company's exposure, as well as the costs to comply with the rules, followed by tax treatment,16 governance requirements and risk of losing management control.

Figure 2.13. Non-listed companies: risks and costs of being a public company (0-10 scale)



A company pointed out, as a measure able to facilitate access to the capital market, the simplification and reduction of regulatory requirements.

Non-listed companies' corporate governance practices at firm and market level

When they rated their governance structures and practices, the surveyed non-listed companies were more positive than in relation to the market practices in general. Their practices were classified with a fairly high rating, and the better rated attributes were transparency and quality of the financial and non-financial information provided to investors, followed by protection of minority shareholders' rights, the regime adopted for related-party transactions, and practices and effectiveness of the Board of Directors.

As to the level of adoption of good governance practices by other companies in the Brazilian market, the rating assigned was only intermediate, and the better rated practices were those related to the Board of Directors and its effectiveness.

Figure 2.14. Corporate governance maturity (0-10 scale)

Key findings

The first finding derived from the responses to the questionnaires is that all companies consider the benefits associated to going public more significant than the costs and potential risks associated to that condition. The responses provided by the companies listed in *Bovespa Mais* access market were, however, more emphatic in rating the listing advantages as exceeding the costs and risks.

Attention is drawn to the fact that, for companies quite smaller than those listed on the main markets, such as those registered with *Bovespa Mais*, the costs related to access to the market are rated as less significant than they are for larger companies.

Considering that the regulatory requirements are practically identical for both groups, a possible explanation for this more favourable perception of the cost-benefit relation of being listed is that it reflects the entrepreneurs' view of the issue. As already commented, the responses by access market companies were provided, for the most part, by the own shareholders and entrepreneurs, whereas, for the listed companies, the respondents were basically persons of their investor relations area. It seems that the strategic aspects of the company's decision for going public are more present and valued by the controlling shareholders.

This is corroborated by the interviews conducted. The interviewees mentioned significant beneficial effects after the company's listing in the access market, even without any capital raising, among which the greater interest from banks in doing business with their companies, with a significant reduction in the cost of capital and greater availability of funds, a higher number of business opportunities and the possibility of issuing bonds in the market. A business owner mentioned that his primary purpose was to signal the seriousness and quality of the company's processes to his clients.

The companies listed on main markets (B3 and Nasdaq) that were interviewed, in turn, focused their comments on issues associated to their relationship with the capital market, such as the attitude of little involvement of investors, the difficulty of obtaining shareholders' participation in general meetings, the level of litigation they face in the US market, in addition to a criticism of what they consider as an excess of regulation and bureaucracy for the listing maintenance.

Another finding concerns the perceptions of the maturity of governance practices. All of the surveyed companies considered their own governance practices at a quite high level of development. In most of the responses, by the way, the self-ratings were more positive than those in regard to the other companies in the Brazilian market.

Corporate governance is not a theme alien to Brazilian companies; in fact, it has been included on the agenda of all companies trading on the capital market for many years. But the adoption of best practices is still quite restricted in terms of number of companies and the level of maturity of the companies' structures and application of governance practices is, in general terms, still modest. This is the view prevailing among those working on the subject in Brazil.

This suggests the need of treating with caution the survey findings particularly with respect to the quality of company corporate governance practices, because, it is quite likely that they are influenced both by the limited size and potential bias of self-reported results and differences between those who were more motivated to respond and those who did not. Nevertheless, the relative rankings of different elements of corporate governance practices can provide some insight into market perceptions of other listed companies' practices.

Finally, in regard to the recommendations to regulators and other policy-makers, the need to reduce the regulatory burden for smaller companies was much mentioned.

Despite such concerns, the interviews with entrepreneurs highlighted other themes with potential to support new companies' access to the market. A special concern was the lack of publicity of cases of success in the access market, considering that the publicity of the advantages of going public would be very inspiring and powerful to motivate business owners. The theme of education for the market among business owners was also cited, with a special mention of the role the stock exchange might play in conveying this message to companies that are not normally looked to by investment banks.

The lack of specialised financial intermediaries willing to take lower-volume transactions to the marketplace, as well as the difficulty of finding investors interested in lower-liquidity stocks are frequently highlighted as obstacles by business owners and private equity and venture capital investors. Cases are frequently cited of companies interested in going public that are discouraged by investment banks based on the argument of a lack of demand for offerings lower than some hundreds of millions of dollars. This discussion, which will be further examined below, was not raised by the respondent and interviewee companies with the same emphasis.

3. Institutional investors

In the aggregate, nine institutional investors[17], all of them based in Brazil, responded to the questionnaires sent, of which: (i) seven asset/fund management companies; (ii) one pension fund, which is one of the largest Brazilian pension funds; and (iii) one wealth management company. Among the mutual fund managers, only one company identified itself as a hedge fund manager.

In terms of size, two fund managers and respondents are among the largest in the Brazilian market, with Assets under Management (AUM) exceeding USD180 billion each, whereas the others are medium or small fund managers. Two small fund managers are specialised in investing in unlisted or low-liquidity listed companies.

One-third of the respondents are part of financial conglomerates, whereas the others are independent investors.

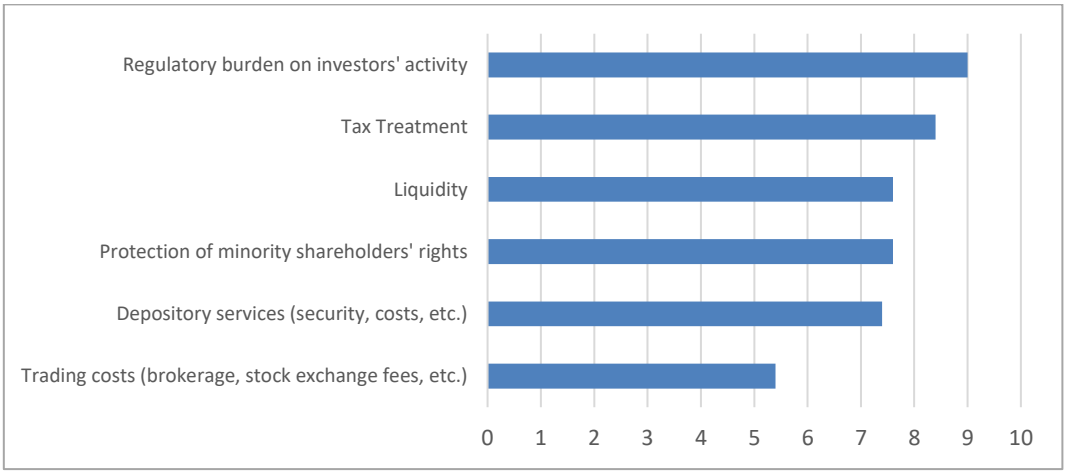
As to their equity investment strategy, 40% of the answers define it as actively managed, whereas only 15% admit to pursuing an index-based strategy[18]. Some of the respondents referred to caps imposed by regulation to investments in individual instruments and, in the case of pension funds, a cap to investment in equities.

Survey results

Trading home and abroad

Fifty-six percent of the investors reported that in the last year they traded on regulated markets outside South America. Such respondents rated the regulatory burden on investors' activities and the tax treatment as the most significant reasons for trading on foreign markets. They also cited foreign market liquidity and the level of protection of minority shareholders' rights as moderately significant reasons for trading in foreign markets.

Figure 3.1. Reasons for trading abroad (0-10 scale)

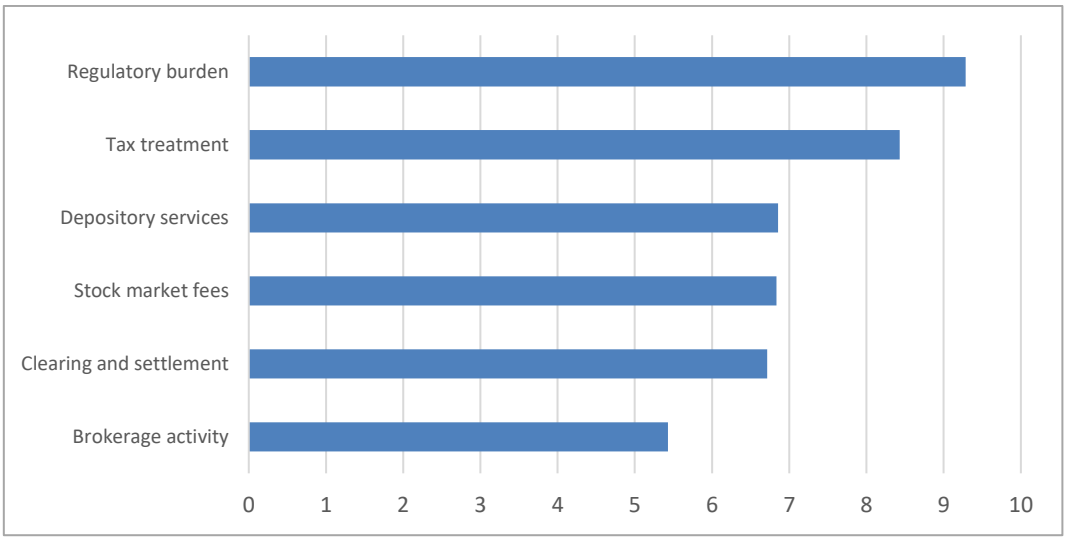


Concerning regulatory requirements related to trading abroad, it is worth mentioning that, in 2015[19], the Brazilian regulation on mutual funds was the subject of an extensive review, which removed some regulatory barriers to the performance of investments abroad that existed until then, even for funds distributed to retail investors. Furthermore, another important issue is that the recent marked reduction in the historically high benchmark interest rate of the Brazilian economy, which remunerates government bonds and has always been responsible for the absolute preference for fixed-income funds in Brazil. The interest rate drop has been causing the investment market to move towards a greater diversification and risk appetite by means, for instance, of a greater investment in foreign assets.

In the aggregate, seven investors expressed an opinion on whether trading costs are a barrier for further developing the domestic equity market. Six (86%) responded that it is, however not significantly, whereas one (14%) considered that these costs represent a significant barrier to the capital market development.

The same respondents understood that it is important to reduce the regulatory burden and change the tax treatment[20] to foster a reduction in the transaction costs. They further considered that it is relatively important, for the same purpose, to obtain a decrease in the costs referring to depository services, stock exchange fees and clearing and settlement.

Figure 3.2. Relative importance of areas to lower trading costs (1-10 scale)



Engagement with companies and perceptions of listed company corporate governance practices

Ninety percent of the investors reported that they regularly engage with the companies in which they invest. All of them informed that they voluntarily adopt as a form of engagement the exchange of communications with the senior management and the investor relations area, as well as engage in collective action with other investors. Seven out of the eight respondents that regularly engage with the investees on a voluntary basis vote in shareholders meetings, whereas six out of eight informed of interactions with companies prompted by the review of corporate governance reports, communications with Board members and nomination of candidates to the Board.

Table 3.1. Engagement with invested companies (%, out of 8)

	Legal/regulatory mandate	Voluntary practice
Voting at shareholders' meetings	62,5%	87,5%
Interactions with companies prompted by the review of corporate governance reports	25,0%	75,0%
Communications with senior management	12,5%	100,0%
Communications with board members	12,5%	75,0%
Request information to the investors relations unit	12,5%	100,0%
Nominate candidates to the board	25,0%	75,0%
Engage in collective action with other investors	25,0%	100,0%

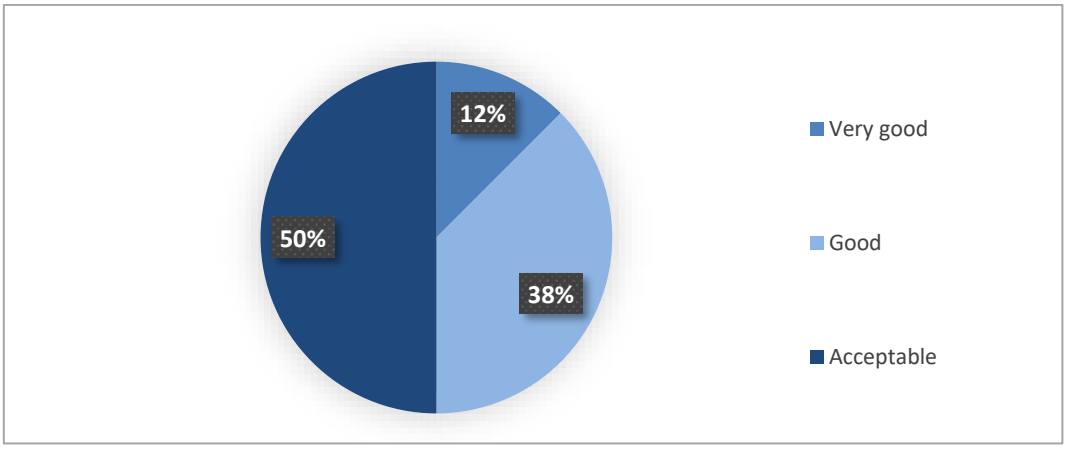
A part of the investors mentioned regulatory or legal requirements as a further reason for their regular engagement with the investees. However, considering that such practices are not a legal or regulatory requirement in Brazil, it seems that the respondents intended to refer to the self-regulation rules or even to their view of their fiduciary duty as managers of third parties' funds.

This high level of engagement by institutional investors is not observed in the market as a whole. Despite a greater mobilisation to vote in general meetings and even to appoint members to the Board having become perceptible over the past years, it is very far from the intensity with which it is observed in the group of respondents to the survey. In fact, most of the managers of Brazilian funds are far from an activist or engaged attitude, even in regard to simple issues such as voting in general meetings.

A circumstance that may explain, at least in part, the scenario obtained from the responses, is the fact that most of the investors who responded to the survey are associated with the Association of Capital Market Investors (*Associação de Investidores no Mercado de Capitais* or "AMEC"), the major investor advocacy organisation in the Brazilian market that recently launched a self-regulation code that seeks, among other purposes, to encourage the participation of institutional investors in the day-to-day life of the issuers of invested securities[21]. Another possible explanation is the sample bias, resulting in differences between those who were more motivated to respond and those that did not.

In responding to the question "*How would you rate listed firms' commitment to good corporate governance practices in your domestic market*", between very poor and very good, 50% rated such commitment as intermediate or acceptable, while the other 50% rated it as good or very good.

Figure 3.3. Commitment to good corporate governance practices



Two-thirds of respondents considered the importance of corporate governance as a factor in their investment decisions as high or very high, and the others considered it moderately significant.

When asked if better corporate governance practices would lead them to increase the exposure to domestic equity, the investors were divided: 33% responded negatively, whereas another 56% responded affirmatively.

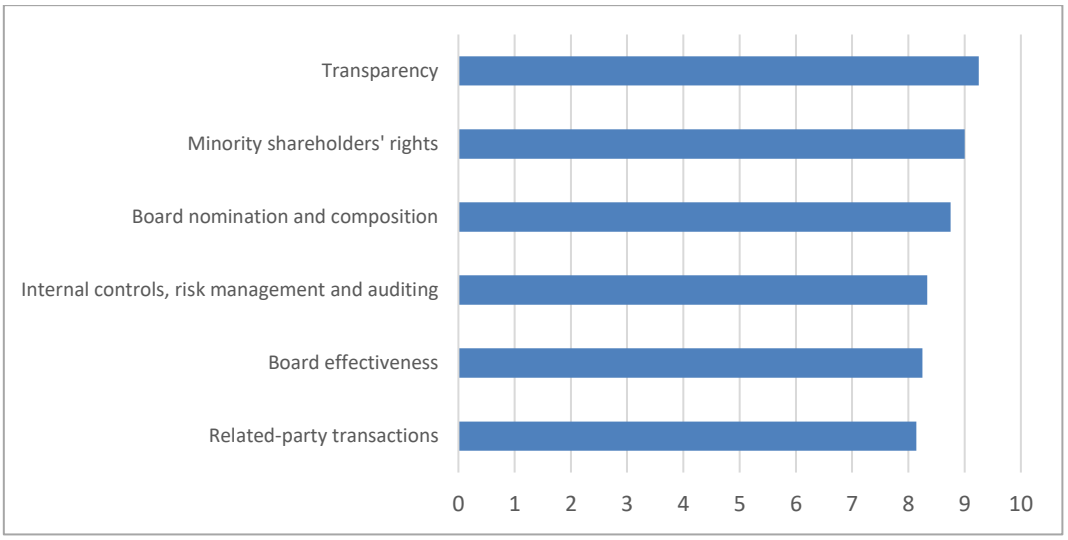
Those who responded negatively to this question stated that their investment in equities is already high, hence any improvement in the corporate governance of Brazilian companies would not cause them to increase their exposure to that asset class.

On the other hand, to explain his affirmative response, a participant was emphatic in pointing out the poor quality of the corporate governance in Brazil, the insufficient protection of minority shareholders' rights and the unsatisfactory performance of the CVM in this regard. He further mentioned that the fines imposed by the capital markets regulatory authority are low in addition to the lack of legal precedents on compensation for minority shareholders' losses.

Some investors pointed out that an improvement in the corporate governance of Brazilian companies might represent a higher potential of appreciation for the equity investments, thereby justifying a higher exposure to those assets. Others, in addition, mentioned that governance is one of the attributes evaluated in their decision on investments in all classes of assets and that negative examples in regard to this issue are considered very significant in their evaluation.

In terms of the required improvements in governance practices, the priority issues were transparency, followed by minority shareholders' rights and Board nomination and composition. Slightly lower priority was given to internal controls, risk management and audits; board effectiveness; and, finally, related-party transactions practices.

Figure 3.4. Corporate governance priority areas to be improved (0-10 scale)



Bottlenecks to invest in smaller listed companies

All respondents considered the lack of liquidity the major bottleneck to invest in smaller listed companies. Further constraints cited in this regard included not being part of an index and the lack of analyst coverage.

To further the development of the domestic equity market, liquidity, especially for small and mid-caps, was most frequently mentioned as an essential factor. A participant pointed out that it is necessary to implement policies that remove the obstacles that hamper the development of private mechanisms of long-term financing in the Brazilian economy and therefore develop the capital market. The participant specifically said that such policies need to : (i) reduce the interest rate on short-term bonds; and (ii) reduce the liquidity premium.[22] In turn, another respondent mentioned the need to have brokers/sponsors focused on bringing smaller companies to the market.

On what they would recommend to regulators to facilitate and promote the participation of institutional investors in equity markets, two participants mentioned simplifying and reducing the burden of regulation for investors and for smaller companies. Another recommended that regulators ask for more transparency and lower the cost of litigation for minority shareholders. One participant suggested that the regulator should be more effective and should favour minority shareholders and not only the controlling ones, as it happens today, according to his perception.

Key findings

The investors who responded to the questionnaire mentioned the lack of liquidity as the major reason for not investing in smaller companies' equities.

That was also confirmed in all interviews. Some interviewees further mentioned structural factors of the Brazilian environment that condition fund managers' strategies and render liquidity such an essential attribute.

According to these interviewees, factors associated to the Brazilian macroeconomic and institutional environment condition the market to a behaviour highly focused on the short term. They point out that the Brazilian market is permanently affected by the huge economic, political and even institutional instability faced by the country, subjecting it to very high interest rates during a long period of time.

This lack of stability and predictability is more damaging, as it would be expected, for smaller companies, naturally more vulnerable to such volatility. In this context, they point out that the cost of the lack of liquidity is particularly high, given the high number of smaller companies that do not survive the turbulences. Further to the trading difficulties inherent to a shallow market, in Brazil, the business risks are higher.

In this same line, an investor commented that, on account of the macroeconomic instability, small caps have been a class of assets with a poor performance in Brazil, differently from the history of this class in the US market, for instance, which has ended up reducing the demand for such assets.

Such instability may have also discouraged foreign investors more focused on long-term investments, and may have prevented the development among the Brazilian population of a long term-savings culture by means of the capital market.

Managers interviewed also raised the issue of a minimum scale required to generate interest in small caps offerings. Given the large portfolios administered by most managers, the

minimum amount an investment must have to justify the effort dedicated to its analysis will always be much higher than the amounts involved in any SME's equity offerings.

Another theme that was addressed in both the questionnaire and interviews concerns the investors' perception of corporate governance practices of Brazilian publicly-listed companies. 50% of investors rated listed companies' commitment to good corporate governance practices as intermediate or acceptable, while the other 50% rated it as good or very good.

Indeed, the interviews corroborate this perception. None of the investors interviewed mentioned the governance of Brazilian companies in a negative manner. Despite their mention that corporate governance is always a point of concern when they decide on an investment, the level of practices in Brazil was considered reasonable and higher than that observed in other emerging markets.

Nonetheless, the interviewees recalled the very negative effect of several emblematic cases involving large publicly-listed Brazilian companies, which have harmed domestic and foreign investors and significantly affected Brazil's image in respect to corporate governance.

4. Perspectives from other stakeholders

While Brazil's success may be considered reasonable in developing a market for initial public offerings since the beginning of the last decade with the creation of the Novo Mercado, an important limitation has been the concentration of IPOs with very high volumes. Only a small number of offerings were successful with volumes below USD 300 million.

This focus on larger volume IPOs has limited the exploitation of all benefits the capital market may convey to the country. Considering that SMEs form the majority of companies in operation in Brazil, as it happens in any economy, the availability of mechanisms for access to long-term capital that adequately meet this segment's needs is an especially significant factor for economic development, as well as for promotion of innovation and economic dynamism.

Also for those who need to allocate their savings, investors and managers of third-party funds, the relatively small number of companies available for investment in the market results in an aged stock exchange, in which the more dynamic sectors are scarcely or not even represented. As a consequence, all investors end up competing to invest in the same few mature enterprises, in general, and in those having a higher liquidity, in particular, driving up the share values of the most liquid stocks at the expense of less liquid ones.

The abovementioned scenario is further complicated by the fact that the market lacks intermediaries dedicated to the small caps offerings segment. This has been perceived as an obstacle by those who attempt to develop an IPO market for SMEs. In view of the high concentration and large size of the intermediaries currently operating in the country, the perception of several companies and investors interviewed is that those intermediaries, in general, are not interested in making smaller companies' public offerings, considering that the level of remuneration would naturally be lower than that obtained with large transactions.

As one of the interviewees described it, in Brazil, SMEs and Brazilian investors are back-to-back to each other, and, at this moment, there are no intermediaries operating to make them turn around.

"Equity Financing SMEs through Capital Market" Report (2012)

To better understand the problem and its causes in order to be able to take measures to solve it, several market and Brazilian government players met in 2012 to diagnose the situation. For that, they studied seven cases of markets that are distinguished for their success in promoting small caps offerings.[23]

The diagnosis, as it was already expected, did not produce ready answers able to solve the bottlenecks observed. The analysis of several cases of successful small caps offerings markets showed that there are local particularities that explain most of these results. In addition, basically none of the enabling conditions observed in each one would be able to be directly applied in Brazil.

Despite these findings, the study allowed the group to draw some conclusions and, based on them, prepare proposals that were somehow inspired by the experiences of those successful markets.

The major conclusions of the study, published at the end of 2012, may be summarised as follows:

- There are structural and cultural conditions associated to the viability of a significant number of SMEs raising capital in the market, represented by either the risk willingness and appetite on the entrepreneurs' and intermediaries' part, or the same risk willingness, however without necessarily having a short-term exit mechanism, on the investor's part. These cultural characteristics are quite different from the Brazilian background, which was much impacted by the macroeconomic scenario and the prevalence of high rates of return offered by government bonds, further to the huge volatility of the economic and political environment. According to the authors of the study: "*the functioning of other markets is strongly based on market practices: alignment of interests to reduce investor risk perceptions; a network of intermediaries that reaches out to investors; and a culture of investment and risk*."
- The regulatory frameworks studied ensure discounts, in terms of requirements, to issuers listed on alternative or access markets. There is a great variation in the level of these discounts, but the most significant observation is that such waivers of requirements do not result, in general, in fixed costs lower[24] than those observed in the Brazilian market for initial public offerings of comparable size. The greatest advantage of these more flexible regimes, according to the findings in the study, seems to be the speed to market, the ability to get to the market during windows of opportunity with more agility, which certainly contributes to reducing the issuers' risk of an unsuccessful offering; and
- The study brought examples of initiatives that were adopted in the markets studied in the fields of regulation and tax treatment, indicating that the public sector can make a relevant contribution to the development of the capital markets as a source of funding for SMEs in Brazil. Policies observed in some of the countries were: (i) specific tax incentives for investors in SMEs; (ii) fostering the creation of specific investment vehicles for this market; (iii) specific rules to facilitate access to the capital markets by SMEs, including disclosure rules; and (iv) SMEs are offered financial assistance to cover the expenses associated with the pre-listing process.

As a result of the process of discussions, based on the study, the following major measures were proposed and implemented, by the end of 2014:

- Measures to foster the creation of investment funds directed towards the investment in good-governance SMEs, by means of adjustments to the regulation of stock investment funds and private equity funds enacted by CVM;
- Discrete simplification of the public offering process, further to the regulation of the "private" placement (defined as a public offering with restricted distribution efforts) of stock by CVM;
- Enactment of a law eliminating the requirement for publication of financial statements and corporate actions in any Official Gazette; this obligation was replaced by a summarised publication in any widely-circulated newspaper and by a full publication on the internet, for eligible companies. Mandatory official

publications represent a significant portion of the listing maintenance expenses of small-sized publicly-listed enterprises in Brazil;

- Enactment of a law granting exemption of income tax on capital gains realised in sales of stock on stock exchanges, effective up to 2023, for individual investors acquiring stock in eligible companies in IPOs, follow-ons or secondary-market offerings; and
- The same law granted exemption of income tax on earnings obtained by individual investors upon redemption of shares in open-ended investment funds that meet certain requirements and are focused on stock in access market enterprises.

Unfortunately, the effectiveness of this set of adjustments made in the Brazilian regulatory environment has not been able to be fully tested yet in view of the serious economic recession faced by the country in 2015 and 2016, which resulted in decreases in GDP by, respectively, 3.8% and 3.6%, and which directly affected the capital market.

It is still not possible to draw conclusions on the ability of these measures to reach the intended result, but it is possible to observe that the resumption of the IPO activity that was observed in 2017 maintained the characteristic of the period prior to the crisis and to the adjustment measures implemented by the government: all transactions consummated involved high absolute amounts, 30% of them in the range between USD200 and USD300 million and the other 70% of the IPOs having raised above USD 300 million.

CVM's Equity Crowdfunding Regulation

As to other initiatives aiming at the capitalisation of small-sized enterprises since the implementation of the measures proposed by the group based on the diagnosis, CVM's July 2017 regulation[25] of equity crowdfunding deserves a special mention.

The rule waived the registration of public offerings of stock up to R$ 5 million made within a 12-month period by companies not registered with CVM that have obtained up to an annual gross revenue of R$ 10 million[26].

Such offerings can only be conducted by means of crowdfunding platforms registered with CVM that, under the rule, assume certain obligations, namely: disclosure of essential information and documents on the issuer and the offering[27]; provision of data on the status of the offering while it is open; administration of the settlement of the transaction upon its end; diligent monitoring to check whether the issuing company is complying with the requirements in the rule and is providing true and sufficient information.

The investment by individual retail investors is allowed, subject to certain limits and the responsibility for monitoring the meeting of these limits also remains with the platform[28].

Interviews with CVM representatives and other stakeholders

In the opinion of one of the interviewees, the founder and CEO of one of the major Brazilian crowdfunding platforms, the regulation was very positive for the business, and contributed to assign credibility to issuers seeking investors' funds by means of equity crowdfunding.

CVM's representatives who were interviewed reported that a legal measure from the package that resulted from the smaller offerings diagnosis study previously mentioned is still pending regulation. The summarised publication of financial statements in newspapers

by eligible SMEs will only be able to take place when CVM clarifies its requirements for summarised financial statements, a rule that is still in process of preparation.

CVM's representatives pointed out that one of the measures adopted by the regulator as an answer to the proposals of the study, namely, the permission of equity offerings with restricted distribution efforts to obtain a waiver of registration, has proved to be quite useful. Several follow-on offerings were made by publicly-listed companies that resorted to this waiver and reached the market with a greater speed and lower costs.

However, these interviewees consider that there is a limit to the regulatory discounts that may be granted to SMEs' offerings consistent with CVM's mission of protecting investors. Furthermore, in their opinion, even the granting of very high discounts would not be able to tackle any of the structural problems affecting this market. Despite such, CVM is engaged in an effort to rationalize rules aimed at reducing compliance costs for Brazilian market participants.

A private equity fund manager interviewed considered that the equity crowdfunding regulation created a viable path of access to capital for start-ups and other very small-sized enterprises with potential to grow. He also considered that there is an IPO market for those enterprises with size to make offerings of USD500 million or over. However, he stated that all other enterprises located between these two extremes do not seem to have an alternative of capitalisation in the public stock market.

Another private equity manager also mentioned the need for a market for SMEs offerings as an alternative for the exit of their investments. In his opinion, the bottlenecks for small-caps offerings have increased over the years due to a process of concentration that reached the intermediation industry as well as the fund management sector. Today, the number of brokers is much lower than 10 or 15 years ago, and the number of fund managers has also decreased as a consequence of the concentration of volumes in very large entities. This increases the inconsistency between the minimum scale demanded by these players and the absolute value of the offerings by smaller enterprises.

The trend towards concentration was also the result of the crisis faced by Brazil between 2014 and 2016. One interviewee cited as an example that, in 2013, 40 potential institutional investors for the IPO of an SME were identified, whereas now only four or five of them are still operating in the market.

5. Conclusions and policy options or recommendations

Reducing regulatory burdens

In addition to structural factors affecting Brazil's economy and capital markets, which will be discussed below, another obstacle mentioned by investors and companies was heavy-handed regulation. Two points always come up in any discussion of improved conditions for access to the capital market: (i) the rules to which participants – both companies and asset managers -- are subject; and (ii) the cost of compliance.

However, this restrictive factor was not seen as the most material or greatest obstacle to developing the capital market. As mentioned in section 2, the companies that responded to the survey questionnaire believed that the benefits of listing outweighed its costs and other additional risks related to being a public company. Likewise, as summarised in section 3, investors believe that this factor was not the main obstacle, although it is an aspect to be improved. In this respect, some of the more specific suggestions from interviewees will be forwarded to regulators and self-regulators for their assessment.

Note that at the time of writing the CVM was leading an effort to rationalize rules for various types of market participants that will cover public companies and asset managers as well as rules for public offerings. The regulator was working with market entities and the stock exchange (B3) to gather proposals and examine them in order to draw up an agenda of improvements capable of lowering the cost of compliance for the Brazilian capital market.

Corporate governance quality and investor protection

The investors' perception of corporate governance practices of Brazilian publicly-listed companies was another theme that was addressed in both the questionnaire and interviews. When asked to rate listed firms' commitment to good corporate governance practices in the domestic market, between very poor and very good, 50% have rated such commitment as intermediate or acceptable, while the other 50% rated it as good or very good. The interviews made with investors corroborate this perception.

Despite their mention that corporate governance is always a point of concern when they decide on an investment, the level of practices in Brazil was generally considered reasonable and higher than that observed in other emerging markets. Nonetheless, the interviewees recalled the very negative effect of several emblematic cases involving large publicly-listed Brazilian companies, which have harmed domestic and foreign investors and significantly affected Brazil's image in respect to corporate governance.

Governance was not a matter of concern for the companies that responded to the survey. Asked to rate their own governance structures and practices, they gave them high scores. The practices adopted by other listed companies were seen as fairly good too, although mostly they were rated slightly lower than the self-reported scores.

Although the findings from this survey should be seen as somewhat relative, given the limited number of participants, the numbers are at least consistent with the view that

corporate governance practices do not appear to be one of the key obstacles to the development of the Brazilian market.

Nevertheless, it is important to mention that corporate governance is still a matter of special interest among the Brazilian market's entities and authorities. In this regard, attention is drawn to two recent initiatives that confirm this statement.

Firstly, at the end of 2016, the Inter-Entities Working Group (GT Interagentes) -- a group composed of 11 of the most important entities related to the Brazilian capital markets -- launched the Brazilian Corporate Governance Code - Listed Companies (Código Brasileiro de Governança Corporativa – Companhias Abertas).[29] The Code was developed with the IBGC Code of Best Practices of Corporate Governance as its basis. It follows the "comply or explain" model, with its purpose to give companies a chance to report to the market those principles and recommended practices of corporate governance effectively implemented by them, and to otherwise explain why a given principle or practice is not adopted. CVM made a significant contribution to the adoption of the Code by enacting a rule that obliges listed companies to disclose its adherence to the Code in the form of a new annual public report.[30]

Secondly, a new version of the Novo Mercado Listing Rules entered into force as of the beginning of 2018. In addition to changes made in order to update some rules considered aged by the market, the new Rules introduced a new chapter about supervision and control. Among other rules, this new chapter establishes that companies listed in the Novo Mercado must have a board audit committee, and compliance and internal auditing areas.

Moreover, despite the view that corporate governance is not the current main problem preventing the development of Brazilian capital market, the recent high-profile cases of corruption and mismanagement of public and private funds by listed companies have highlighted once more a problem that has been well known to the Brazilian capital market: the lack of viable mechanisms for the private enforcement of rights by the investors. Resorting to the courts to recover losses or to obtain redress is an impossible endeavour in Brazil, due to legal and practical obstacles that turn it into a costly and unpredictable process.[31] And the absence of such mechanisms significantly reduces the incentives for company management and controlling shareholders to behave according to the best corporate governance practices.

While the investors in Brazilian companies' securities traded in the United States were able to join class actions to seek redress, the investors in Brazil are not entitled by the law to promote class actions. These recent developments have prompted the CVM and the Brazilian Finance Ministry to create, in April 2018, a task force dedicated to minority shareholders' rights, targeting the analysis of alternatives to improve the conditions for investors to use the legal system to recover losses, and to reducing the existing barriers.

Facilitating SME access to equity markets

As discussed in section 4, the diagnosis of the group that analysed impediments to the success of a market for SMEs in Brazil led to proposals for regulatory changes and the authorities had implemented most of them by 2014. Unfortunately, the effectiveness of that set of adjustments made in the Brazilian regulatory environment has not been fully tested yet in view of the economic recession faced by the country in years 2014 to 2016, which directly affected the capital market.

It is still not possible to fully assess these measures' ability to reach the intended result, but it is possible to observe that the resumption of the IPO activity that was observed in 2017,

even after the implementation of said measures, maintained the characteristic of the period prior to the crisis: all transactions consummated involved high absolute amounts, 30% of the offerings in the range between USD 200 and USD 300 million and the other 70% of the IPOs having raised above USD 300 million.

The survey results and the discussions conducted for this report suggest that the biggest obstacle to the development of the Brazilian capital market is structural and it is related to the instability and lack of predictability that have constantly characterised the country's economy, in addition to its extremely high interest rates over long periods of time. Irrespective of the causes, this situation directly affects the Brazilian market's characteristics and participants have to take a short-termist approach, if only for defensive reasons.

The investors who responded to the questionnaire mentioned lack of liquidity as the major reason for not investing in smaller companies' equities. That was also confirmed in all interviews. It seems that lack of stability and macro conditions are largely responsible for making liquidity such an essential attribute.

This lack of stability and predictability is more damaging, as it would be expected, for smaller companies, naturally more vulnerable to such volatility. This means that investors believe that the cost of the lack of liquidity is particularly high, given the number of smaller companies that do not even survive the crises. Further to the difficulties inherent to trading in a shallow market, in Brazil, the business risks are higher.

In this same line, an investor commented that, on account of the macroeconomic instability, small caps have been an asset class with a poor performance in Brazil, differently from the history of this class in the US market, for instance, which ends up reducing the demand for such assets.

Fund managers also have to respond to the same short-term focus shown by their investors and this behaviour was again accentuated by Brazil's 2014-2016 crisis. This meant that the industry as a whole had to step back from strategies based on less liquid assets in order to ensure almost immediate liquidity for redemptions. As an interviewee said, fund managers cannot control the behaviour of unit holders or shareholders who are not willing to give up liquidity in exchange for potential gains.

The relevance of the economic environment and the need to transform Brazil's market culture

A pause here is called for in order to look at another aspect that is often mentioned: individual Brazilian investors and their investment culture (or its absence) in relation to the stock market. Likewise, another presumed cultural aspect is that businessmen have little appetite for being listed on the exchange. Once seen in perspective, however, given the abovementioned environment of insecurity and extreme lack of predictability, it would be more reasonable to see this behaviour as a conditioned response or even a requirement for survival rather than mere risk aversion.

In the course of the Brazilian stock market's several boom and bust cycles, generations of investors and businessmen have sought closer involvement with the market but got their fingers burned. There has been no gradual building of a broadly-based set of people who have experienced the levels of risk and volatility that may reasonably be expected of risk markets, including gains and losses. Episodic generalised losses tend to drive these participants away from the market forever.

One investor interviewed stated that Brazil will only succeed in developing an SME-friendly market when there is more security and confidence in the economy, since accepting lower levels of liquidity would require stability and predictability. Many affirm that the lack of institutional and individual investors specialised in investing in SMEs is the cause for Brazil's failure to date to create a market for smaller IPOs. In this interviewee's contrary opinion, the existence of an active market for SMEs as well as a substantial number of investors with this focus would in both cases be a consequence of a scenario of stability and predictability with low interest rates for a prolonged period. These conditions are present in countries that have succeeded in developing access markets, as shown by the study mentioned in section 4.

The conditions imposed by market structure

In addition to the important challenges posed by the macroeconomic environment, there are market structure factors making for this scenario of a market that has not adapted to meet SME needs. These latter factors must be adequately identified and understood since they too are necessary conditions for success or failure of any measures adopted.

The structure of brokerage and asset management industries in Brazil, which was already very concentrated in a few major players, moved even further in this direction due to the 2014-2016 crisis, which led to the exit of a number of asset managers and brokers from the market. Today, the number of brokers is much lower than 10 or 15 years ago, and the number of fund managers has also decreased as a consequence of the concentration of volumes in the largest entities. This increases the inconsistency between the minimum scale demanded by these players and the absolute value of the equity offerings by smaller enterprises.

This is a characteristic of the market that regulators and policy makers may not easily alter, so it should be taken into account when devising measures to develop an access market in Brazil.

Since investment banks have not shown interest in SME offerings, the exchange has for years made a number of unsuccessful attempts to sensitize brokerage firms and enable them to act as leaders for share offerings. This business has not been part of brokers' roles in the Brazilian market since the 1990s or earlier and, despite the efforts made, none has decided to specialize in this niche. Once again, it may be the case that an activity that invests in long-term relationships with issuers, such as financial advisory services for SMEs, will not fit within the horizon of these players, given Brazil's highly volatile economy.

Given the absence of financial institutions willing and able to take SMEs to the market, it may be worth considering a regulatory change that will make this requirement more flexible in a new market environment with over-the-counter market characteristics. Investors interviewed for the survey suggested that an alternative that could eventually disintermediate these offerings might be worth examining.

Possible inspirations: European organised OTC markets and CVM's equity crowdfunding regulation

One reference is the European model for organised over-the-counter markets[32], with which some countries have been reasonably successful in providing access to markets for SMEs. This model, which does not require registration for issuers or offerings, was studied by the group that compiled the diagnosis in 2012 and is reasonably well known to the CVM itself.

In this type of market, which is classified as unregulated, the most important role is played by the stock exchange as a self-regulating entity. It typically makes the rules for listing and corporate governance, accredits financial advisors and oversees how different participants meet their obligations.

In relation to equity crowdfunding, the CVM's regulatory choices have so far met with a positive response, having shown initiative and willingness to deal with new aspects of the current situation driven by technology and the growing levels of autonomy of individuals in the market. These same characteristics should be considered in any assessment of how to create a more viable environment for offerings of smaller volumes than those accepted in the mainstream market.

On the fundamental issue of protecting investors, an important task for the authorities is to properly understand the characteristics of a portion of new investors now trading in the market. Many of them manage their own investments directly through online brokers and open architecture platforms dealing in financial products. In addition to having a greater volume of easily accessible information about issuers and their businesses from research tools and public sources, there are now independent research firms that are not attached to banks or brokerage firms, who have exactly the same individual investors as their target audience and they are the ones who usually cover listed companies with less liquid shares.

These types of investors, as mentioned by a small cap company interviewed for the survey, ensure the relative liquidity afforded by its shares. This is because the few institutional investors in that company's shareholder base have a long-term buy-and-hold behaviour.

In the previous century, efforts made to build up in Brazil an organised over-the-counter market failed and were abandoned, because the market in question was eventually stigmatised by illegal practices among participants. However, this type of behaviour would be less likely today due to stronger oversight structures, so the idea seems worth revisiting. The self-regulatory entity –B3– nowadays is strong and respected, having consolidated its role, and it is actively supervised by the CVM itself, so the scenario is quite unlike the 1990s.

Notes

[1] Unless otherwise noted, all data was obtained from *B3 – Brazil, Bolsa, Balcão*.

[2] *See* PARK, Joonkyu, *Brazil's Capital Market: Current Status and Issues for Further Development*, IMF Working Paper nº 12/224, available at https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Brazils-Capital-Market-Current-Status-and-Issues-for-Further-Development-26254.

[3] *Source: Santana*, M. H. (2008), "The Novo Mercado*"*, Novo Mercado and Its Followers: Case Studies in Corporate Governance Reform, International Financial Corporation Global Corporate Governance Forum – Focus 5, available at https://www.ifc.org/wps/wcm/connect/e1162a8048a7e69ea787e76060ad5911/Novo%2BMercado%2Btext%2Bscreen%2B4-21-08.pdf?MOD=AJPERES.

[4] *See De Barros*, J. R. M.; *Scheinkman*, J.A.; and *Cantidiano*, L. L. (2000), "Desafios e oportunidades para o mercado de capitais brasileiro" [Challenges and Opportunities for the Brazilian Capital Market], published by BOVESPA – Bolsa de Valores de São Paulo.

[5] *See* Note 4.

[6] The study analysed all the companies listed on the Novo Mercado, on Level 2, on Level 1 and the 50 most traded companies of the traditional segment, excluding the companies that were in "Chapter 11" at the time. The study, which was based on the public information provided by the companies, used the following criteria: (i) majority control: if a single individual or company owned more than 50% of the company's voting shares; (ii) shared control: if individuals and/or companies each owned less than 50% of the company's voting shares, but there was a shareholders' agreement among them binding more than 50% of the company's voting shares; (iii) dispersed control: if there were no individuals or companies that owned more than 50% of the company's common shares, even if jointly.

Source: KPMG, ACI – Audit Committee Institute (2018), "A Governança Corporativa e o Mercado de Capitais".

[7] *Source:* CEMEC (June 2017), "Nota CEMEC 05/2017", on page 15. Available at http://ibmec.org.br/instituto/wp-content/uploads/2014/10/NOTA-CEMEC-05-2017-PADRAO-DE-FINANCIAMENTO-DOS-INVESTIMENTOS.pdf.

[8] Anyhow, bank credit as a percentage of the Brazilian GDP corresponded to only 52.2% in January 2014 (before the 2014-2016 crisis) and to 46.6% in the same month of 2018. *Source*: FEBRABAN, "Panorama do Mercado de Crédito", available at https://portal.febraban.org.br/pagina/3130/21/pt-br/panorama.

[9] *See* Note 8.

[10] *Source*: ANBIMA, available at http://www.anbima.com.br/pt_br/informar/relatorios/mercado-de-capitais/boletim-de-mercado-de-capitais/empresas-brasileiras-captam-volume-recorde-no-mercado-de-capitais-em-2017.htm. It must be noted that this analysis is based on data through the end of 2017, and does not refer to the more recent slow-down in capital market activity during 2018).

[11] See Note 10.

[12] The exceptions to that have been mostly companies within industries that do not have peers listed in the Brazilian exchange, but which can find them in a foreign market, enabling them through cross-listing to command better valuations in their IPOs.

[13] Companies that are part of the theoretical portfolio of the Brazil Index 100 – IBrX 100.

[14] In one of the cases, after having been acquired by a US acquisition company, the merged company was listed in NASDAQ at the end of 2017, whereas another company registered with the US SEC is listed on B3's main market by means of a Brazilian Depository Receipt (BDR) program.

[15] It is important to mention that, in Brazil, there is not any distinction between the tax treatment given to publicly-held and closely-held companies. However, in view of the need to render accounts to the shareholders, as well as of the controlling and auditing level to which publicly-held companies are submitted, their competitiveness vis-à-vis some market peers may be impaired, due to the level of informality still existing in many sectors of the Brazilian economy. This issue was expressly mentioned by one of the entrepreneurs who was personally interviewed for the survey.

[16] *See* Note 16.

[17] Out of 56 who received the survey questionnaire and were invited to respond.

[18] Percentages add up to more than 100% because investors could designate more than one choice.

[19] CVM Instruction no. 555/2015.

[20] In Brazil, the tax treatment of mutual fixed income funds is criticised for the collection of income tax twice per year, even if the fund shareholder does not redeem his investment. The market has even given it a name: "come-cotas" or "share-eater" tax. Furthermore, there are types of bonds that are tax exempt, depending on the sector they are intended to fund, like real estate or agribusiness, and not the characteristic of the income that is taxed, creating tax arbitrage reasons for the investors to choose products other than mutual funds in the Brazilian market.

[21] *See Associação de Investidores no Mercado de Capitais* – AMEC *Stewardship Code*. Available at https://en.amecbrasil.org.br/wp-content/uploads/2016/11/livreto_stweardship_eng_site.pdf.

[22] This reference alludes to the fact that liquidity is so important that the yield in more liquid bonds is higher than in the less liquid ones, even when the maturity of the more liquid bonds is shorter, creating distortions in the yield curves.

[23] The working group comprised representatives of ABDI, the Brazilian Industrial Development Agency; BNDES, the National Development Bank; BM&FBOVESPA, the Securities, Commodities and Futures Exchange, now B3; CVM, the Securities and Exchange Commission; and FINEP, the Federal Innovation Agency. Seven countries have been visited – Australia, Canada, China, Poland, South Korea, Spain and the United Kingdom – to find out about alternative stock market rules and practices, success stories, and relevant experiences in these trading environments tailored to the capital-raising needs of small and medium-sized enterprises. The study is available at http://www.bmfbovespa.com.br/pt_br/listagem/acoes/abertura-de-capital/beneficios-para-pequenas-e-medias-empresas/.

[24] *See* Note 24, paragraphs 29 to 36 of pages 12 to 15 of the report.

[25] CVM Instruction 588/2017.

[26] US$ 1,436,328 and US$ 2,872,655 respectively as of May 1st 2018.

[27] The Instruction requires that the platform makes available for 5 years after the offering the following: (i) information about the issuer, including main activity description, annual financial statements, management's CV and main shareholders; (ii) main aspects of the business plan and use of proceeds; (iii) information on the securities being issued and the investor rights attached to them; (iv) description of the ongoing information the issuer commits to provide during the next 5 years; and (v) description of the main risks associated with the investment, possible conflicts of interest, the remuneration of the platform and the applicable tax treatment.

[28] Figures of the amounts raised through the registered crowdfunding platforms were not yet available on CVM's website at the time of writing. The regulation that requires the platforms to be registered is recent and some of them are still in the process of being registered and starting to provide information as required by the regulation.

[29] See Brazilian Corporate Governance Code - Listed Companies, available online (English version) at: http://www.ibri.com.br/Upload/Arquivos/novidades/3877_GT_Interagentes_Brazilian_Corporate_Governance_Code_Listed_Companies.pdf.

[30] CVM Instruction no. 586/2017.

[31] See OECD (2015), *Supervision and Enforcement in Corporate Governance*, on-line: http://www.oecd.org/daf/ca/SupervisionandEnforcementinCorporateGovernance2013.pdf , Chapter 2 on Brazil (pages 43-68), prepared by Maria Helena Santana as a consultant to the OECD.

[32]Examples: Alternative Investment Market (AIM) – UK, Mercado Alternativo Bursátil (MAB) – Spain, New Connect (NC) – Poland.

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