Relatórios Coppead é uma publicação do Instituto COPPEAD de Administração da Universidade Federal do Rio de Janeiro (UFRJ)

Comissão de Pesquisa
Angela Rocha
Rebecca Arkader
Ricardo Leal

Gerência de Publicações
Paulete Thompson

Editoração Eletrônica
Adriana Baptista Pereira

Referenciação e Ficha Catalográfica
Ana Rita Mendonça de Moura

Leal, Ricardo Pereira Câmara.

An evaluation of board practices in Brazil / Ricardo P. C. Leal; Cláudia L. T. de Oliveira -- Rio de Janeiro: UFRJ/COPPEAD, 2001.

13 p. ; 27 cm. -- (Relatórios COPPEAD, 352).

ISBN 85-7508-033-4
ISSN 1518-3335

1. Finanças. I. Oliveira, Cláudia L.T. de. II. Título. III. Série.

CDD: 332

Pedidos para Biblioteca

Caixa Postal 68514 – Ilha do Fundão
21941-970 – Rio de Janeiro – RJ
Telefone: 21-2598-9837
Telefax: 21-2598-9835
e-mail: biblioteca@coppead.ufrj.br
Home-page: http://www.coppead.ufrj.br

An evaluation of board practices in Brazil

Ricardo P. C. Leal
Claudia L. T. De Oliveira[1]

We survey board practices in Brazil. Brazilian companies are commonly controlled by family groups or through shareholders agreements. Controlling shareholders hold a very large portion of voting shares, much more than the minimum necessary to retain control. There is widespread evidence of shareholder expropriation, legal protection is week, and stock issuance has been halted by low valuations and tax avoidance. Half of the boards are either too small or too big. Board committees are ineffective. Board procedures are rarely formalized and board members and CEOs are not evaluated in most cases. Most board members are not shareholders. No more than 21% of board members are independent and only 2% of them are elected by independent shareholder groups. It is likely the improvements in board structure and procedures be restricted to large public corporations with foreign stock ownership while most companies avoid going public.

1 INTRODUCTION

The Brazilian stock market is one of the largest among emerging markets and the Brazilian economy is among the ten largest in the world. Brazil has undergone changes in its corporate governance practices as companies were forced to become more competitive with the opening of its market and the privatization of its companies in the 90's. In addition, institutional and foreign investors have become more active. Many industrial groups realized that partnerships were a good strategy to face this new scenario and so the use of shared control agreements became common (Fontes Filho, 2000; Siffert and Silva, 1999). The importance of a governance system that promotes healthy and transparent relationships among

[1] Dean and professor of finance; MBA student, respectively. The COPPEAD Graduate School of Business. Federal University of Rio de Janeiro.

controlling shareholders, managers, outside shareholders, and creditors is now evident.

Corporate governance is obviously a new subject in Brazil. As ownership and control patterns change, it is necessary to avoid the damages that agency problems can cause, including illicit acts. This should be the main purpose of the board of directors, although, in Brazil and in many other countries, this objective is rarely achieved. The contribution of this study is to review current Brazilian board practices and structure. Before we do this, we present some general characteristics of the Brazilian market with particular emphasis to the protection of shareholder's rights.

2 BRAZILIAN MARKET CHARACTERISTICS

The Brazilian equity market is not very liquid and its primary equity market has not been very active recently. The number of companies going private has been greater than the number of companies going public. Most companies go public through bond issuance and not stock issuance. Trading and new issues have migrated abroad, especially to the US. Claessens et alli (2001) show that the primary market for equities in Brazil is small even when compared to other emerging markets. They cite a number of measures to improve the functioning of the Brazilian capital market, emphasizing corporate governance reforms and minority shareholder rights.

Macroeconomic factors, in particular very high interest rates, raise the cost of new equity capital and crowds out investors from the equity market into the local treasury paper market. Leal (2000) lists a number of problems with the primary equity market in Brazil, including the discretionary allocation process used for new issues that favors institutional investors and tax avoidance. Varsano et alli (1998) show that the Brazilian government obtains most of its revenues in the form of high value-added taxes and through a system of cascading taxes on business gross revenues and gross profits while wealthier countries obtain most of their tax revenues from income taxes. These are very strong incentives for no transparency and tax avoidance that certainly affect the attractiveness to go public in Brazil.

The credit market is strongly affected by these problems as well. Pinheiro and Cabral (1998) show that the Brazilian judiciary is regarded as inefficient. Its main problems are its slowness, costs and partiality. Investor protection is weak. To a large extent, shareholders and creditors finance firms because the law protects their rights. They are more vulnerable to expropriation, and more dependent on the law, than employees and suppliers (La Porta et al., 1999b). In general, expropriation is related to the agency problem described by Jensen and Meckling (1976) because it means that insiders use earnings on their own behalf, instead of returning earnings to investors (La Porta et al., 1999b).

According to La Porta et alli (1999a, 1999b), where laws are protective of outside investors and well enforced, investors are willing to finance firms, and financial markets are both broader and more valuable. In contrast, where laws don't protect investors, the financial market may be less developed. La Porta et alli (1999b) show that the quality of legal protection of outside investors varies systematically across legal origins. The French code law tradition ranks the worst in terms of protecting investor's rights. Brazil has a French code law tradition. The legal rules in civil law systems are made by legislatures and judicial decisions do not incorporate into the law, thus conflicting judge sentences, ignoring the jurisprudence, are common. As a consequence, a corporate insider who finds a way to expropriate outside investors that is not explicitly forbidden by law may be able to proceed without fear of an adverse judicial ruling. However, La Porta et al. (1999b) observe that it would be necessary to consider the inclination of judges to protect outside investors as well as their background and political preferences. Brazilian judges many times have a "social" view and tend to protect labor as opposed to creditors and outside shareholders (Pinheiro and Cabral, 1998). Brazilian bankruptcy law gives priority to labor and to fiscal debts over any form of debt, secured or not, and short term debt is not differentiated from long-term debt (Beck, 2000). The weak protection of investors in Brazil adds value to ownership concentration (Valadares and Leal, 2000).

Aragão (in BNDES, 1999) points out that legal issues related to corporation law are becoming more and more complex and intricate in Brazil. Therefore, legal institutions must provide a higher degree of specialization. The evidence, however, shows that relevant legal decisions in Brazil against management of public companies are rare. Moreover, most minority shareholders don't even think about going to court because the costs of a law suit are often greater than the amount of money under dispute. In spite of that, many professionals think that corporate law in Brazil may allow the development of good corporate governance practices even if there are no significant changes.

There is widespread evidence of minority shareholder expropriation. There is a very high control premium in Brazil (Nenova, 2001; Saito, 2000; Valadares, 1998). Minority shareholders lost their tag along rights after a government induced change in corporate law eliminated it in 1997 to facilitate the transfer of control in privatizations. This right has been re-instated in 2001. Nenova (2001) documents that the control premium doubled after tag along rights were removed and then declined as lost minority shareholder rights were partially reintroduced in 1999. The control premium from public stock quotes estimated by Nenova (2001) pales in comparison to the control premium actually paid in control transfer bloc trades. These premiums may be as high as 800% over the value of non voting shares (Cunha, 2000; Valadares, 1998). Another evidence of expropriation is the widespread use of pyramids. Firms that use such indirect control structures to increase insider ownership present low relative valuations, consistent with greater expropriation of minority shareholders (Leal et al., 2000).

The nature of ownership and the identity of controlling shareholders influence the performance of companies because their strategic choices depend on the interests of such owners (Siffert, 1998; Hermalin and Weisbach, 1991; John and Senbet, 1998). Different ownership structures result in different agency problems and different mechanisms to guarantee efficient allocation of cash flow rights (Valadares and Leal, 2000). According to Valadares and Leal (2000), the agency problem depends on the degree of the company's concentration of ownership. As the concentration decreases, there is a greater incentive for controlling shareholders to monitor management. The benefits of control are usually related to weak protection of minority shareholders rights. Greater ownership concentration, on the other hand, may be associated to greater incentives for outside shareholders to monitor controlling shareholders (Valadares and Leal, 2000).

The Brazilian corporate law allowed for the issuance of 1/3 of voting shares to 2/3 of non-voting shares. This has been changed by the end of 2001 to 50% of voting shares but only for those companies that became public after the law was enacted. This considerably reduces the investment necessary to control a company as it is possible to retain control with only 16.6% of the total capital (50% of 1/3 minimum of voting shares). The patterns of ownership have also changed recently. Siffert (1998) observed a reduction from 44% to 21% of state ownership of companies (until 1998) as a consequence of privatization. He observed a rise in the number of foreign controlled companies and a reduction in the number of family-owned companies, still predominant in Brazil. Diffuse corporate ownership continues to be rare (considering diffuse ownership when there are no shareholders with more than 20% of voting shares).

The rise of shared control under a controlling shareholders agreement was significant, from 5 to 23 companies in 1998, mostly resulting from privatizations (Siffert, 1998). The new majority shareholders are pension funds as well as domestic and foreign companies (19% of the total in 1998). Ownership concentration remains high. The largest shareholder has, on average, 43% of the total equity capital with

61% of the voting capital, while the five largest shareholders hold an average of 58% of total equity capital and 85% of the voting capital (Leal et alli, 2001) in 1998. In 1996, Valadares and Leal (2000) described these controlling shareholders among non-state owned public companies as holding companies (53%), followed by individuals (15%), and foreigners (8%). As a result of such concentration of ownership and control, the relevant agency problem is between majority and minority shareholders. This highlights the importance of boards as an instrument to mitigate these agency conflicts as well as to study which good practices allow better monitoring of majority shareholders by minority shareholders.

3 BOARD PRACTICES

The board of directors is mandatory in Brazil since 1976. In our analysis of Brazilian boards, we reviewed four studies. The 1998 IBGC (Brazilian Institute of Corporate Governance) study used the same model developed by the US NACD (National Association of Corporate Directors) in 1995. It consists of personal interviews in a sample of 120 large companies that represent a significant portion of the Brazilian GDP. The second study by the executive search consulting firm Spencer Stuart (SS) (1999) consists of a questionnaire sent to 840 firms and answered by 92 of them. The third study was performed by Ventura (2000) on a sample of 438 listed companies (75% of the total listed companies) using the data from CVM (the Brazilian Securities and Exchange Commission). The fourth study by Dutra and Saito (2001) concentrates on the role of independent directors. These studies may be representative of the largest public companies in Brazil and may portray the reality of boards accurately. However, it is possible that only companies with better corporate governance practices have replied to the questionnaires or have welcome the interviewers in some of the studies reviewed.

3.1 Board structure

Brazilian corporate law determines a minimum of 3 members in the board. The average board size in the SS (1999) study is 6.8 members while Ventura (2000) shows that 30% of the boards have the minimum legal size and only 50% have the 5 to 9 members recommended by the IBGC Code of Best Corporate Governance Practices (2001).

Conflicts between minority shareholders and controlling shareholders may prevent a board to act effectively. IBGC (1998) indicates that the relationship between companies and stockholders was considered satisfactory by those interviewed, reaching 73% of approval. However, the study finds no evidence of any influence of minority shareholders over the decision making process. According to IBGC (1998), 48.7% of the companies have their directors chosen by shareholders, 17.9% by their CEO, and only 2% by an independent group. Shareholders are represented in 51.2% of the boards, suppliers in 14%, and institutions in 11.6%. However, as controlling shareholders dominate boards, the directors chosen by shareholders cannot be independent in most cases and it is not surprising that respondents that by and large do not represent outside shareholders find the relationship between insiders and the board satisfactory.

Brazilian corporate law permits that the Chairman and CEO jobs be performed by the same person. Ventura (2000) shows that in 41% of them the CEO is the chairman of the board while 72% of the companies have the CEO as a member of the board. According to SS (1999) and IBGC (1998), 70% and 81% of the boards, respectively, separate the two positions. In some cases, the chairman of the board is subordinated to the CEO and, in other cases, the chairman is the CEO substitute. Many times boards function only as advisers. IBGC (1998) shows that 81% of the companies do not have by-laws describing the role and duties of directors.

Controlling shareholders nominate directors who best represent their interests. Board independence is necessary to monitor managers on behalf of all shareholders.

The Brazilian corporate law lets one third of board members to be insiders. Monaco (2000) reveals that an average of 29.4% of listed companies have board members subordinated to the CEO. Dutra and Saito (2001) classified 1058 directors of 142 public companies and concluded that 49% of them represent controlling shareholders, 10% are company executives or insiders of some sort, 20% have interests in the company other than simply holding its stock, acting as their supplier, banker, legal advisor, etc., and only 21% cannot be classified under these three previous categories. However, there is no guarantee that the directors in this “other” category are truly independent directors. This is in sharp contrast with over 50% of board members being independent in the US, according to Bhagat and Black (2000).

Dutra and Saito (2001) also show that only 11% of the firms in their sample meet the IBGC (2001) recommendation of at least 50% of the board consisting of independent directors. Ventura (2000) states that only 23% of board members in his survey are completely independent from management. The IBGC study shows that 27% of the boards do not have any independent directors. Finally, Dutra and Saito (2001) find no evidence of different board composition across firms with or without ADRs, and for foreign, state or privately controlled firms. Dutra and Saito (2001) conclude that minority shareholders do not seem to be interested in board representation even when the law allows for minority shareholders to elect board members, as in the case of boards with less than 5 members or when cumulative voting is allowed.

3.2 Board Committees

SS (1999) finds that only 17.6% of the respondents had permanent committees while the most common committees are, in the order of the frequency they are cited: investments, finance, auditing, nominations, executive, strategic, ethical, environmental, and risk management. Committees do not accomplish much according to IBGC (1998). In fact, only the strategic planning committee seems to be more active (24.3% of the respondents). This same study shows that the other active committees are the auditing (13.5%), financial (16.2%) and nominations (18.9%) committees. Committees do not meet often. The auditing committee is not very well known in Brazil and meets monthly or quarterly only in 10.5% of the cases. Mula (in BNDES, 1999) points out that the board or its committees do not have any influence over the hiring of independent auditors. Less than 15% of the nominations committees meet with any regularity, be it monthly, quarterly, bi-annually or annually. Only 5.4% of the executive committees meet monthly. This low frequency of meetings indicates the lesser importance attributed to them.

3.3 Board evaluation and compensation

In order to assess the performance of the CEO, external and independent directors must meet without the presence of the CEO and inside directors. However, the IBGC study points out that only 13.5% of outside directors hold separate meetings. This is another evidence of the advisory character of Brazilian boards. IBGC (1998) also states that there are no formal processes for board self-evaluation in 67.6% of the cases. There is an individual evaluation of each member of the board and of the performance of the CEO only in 27.9% of the cases. Directors may own stock or stock options, however, IBGC (1998) shows that only 5.4% are paid with them. SS (1999) shows that 22% of directors are not paid and that more than 50% of directors are paid less than US$10,000 per year. Monaco (2000) shows that 71.9% of directors in 647 listed companies are not stockholders. Most represent controlling shareholders because they are frequently elected by them.

4 CONCLUSION

Brazilian corporate ownership is highly concentrated and shows weak legal protection of investor’s rights. The risk of expropriation by controlling shareholders is high due to the weak enforcement of corporate law and bad corporate governance practices. Brazilian research on corporate governance is scarce because interest on the topic is very recent. Companies were required to have boards in 1976 but to this date most public companies have no by-laws for board procedures and evaluation. In addition, we realize that controlling shareholders interfere with the board's work and there are very few companies with a significant number of truly independent board members. Board committees are, by and large, inactive and ineffective. Most board members are not stockholders and most boards do not have a structured evaluation procedure for board members, the CEO or the board itself.

Good corporate governance practices may reduce the cost of capital of Brazilian companies and improve their competitiveness. Among the largest economies in the world, Brazil shows a very small number of internationalized companies. The very high cost of capital faced by the large Brazilian corporations, both domestically and internationally, is a major barrier they must overcome to compete. The pressure is out and Brazilian controlling shareholders are considering the value of good corporate governance practices as one of the ways to lower their cost of capital. Some signs of improvement have been seen in many companies but the number of public companies has been decreasing while IPOs are virtually non-existent. The very high level of interest rates on treasury paper crowds out investors from the stock market and lowers the market value of companies. The high taxation of public companies leads to incentives for less transparency and tax evasion on the part of private companies. The judiciary is perceived as slow, expensive, and biased. Legal protection of shareholder's rights is week. This economic environment is not favorable for companies to go public. While it remains, we may see changes in corporate governance practices on the part of public companies, particularly for those with shares traded abroad, but we will hardly see a large number of companies going public and corporate governance improvements will concentrate on the few public companies that have a relatively large shareholder basis.

5 REFERENCES

Beck, Thorsten. (2000) Impediments to the development and efficiency of financial intermediation in Brazil. World Bank working paper.

Bhagat, Sanjai; Black, Bernard (2000). *Board independence and long term firm performance*. Columbia Law School Working Paper # 143.

BNDES. (1999) Governança Corporativa. Proceedings of an Oct. 1998 seminar.

Claessens, S.; Klingebiel, D.; Lubrano, Mike (2001). *Corporate governance reform issues in the Brazilian equity markets*. World Bank working paper.

Cunha, Mauro. (2000) Governança corporativa e os players do mercado. In: A nova Lei das S.A. e a governança corporativa, Proceedings of the IIR Conference 2000.

Dutra, Marcos G. L.; Saito, Richard. Conselhos de Administração: análise de sua composição em um conjunto de companhias abertas brasileiras. Fundação Getúlio Vargas working paper, 2001.

Fontes Filho, J.R. (2001) *O Sistema de Previdência Privada no País e o Impacto das Práticas de Governança Corporativa: o Papel dos Fundos de Pensão*. Working paper.

Hermalin,Benjamin E.; Weisbach, Michael S. The Effects of Board Composition and Direct Incentives on Firm Performance. Financial Management 20(4), Winter 1991, pages 101-12.

IBGC - Instituto Brasileiro de Governança Corporativa. (2001) Código das Melhores Práticas de Governança Corporativa.

____. (1998) Relatório de resultado de Pesquisa sobre a Governança Corporativa no Brasil – 1998, available at http://www.ibgc.org.br.

Jensen, M.C.; Meckling, W.H. (1976) “Theory of Firm: Managerial Behavior, Agency Cost and Ownership Structure.” Journal of Financial Economics, Vol. 3, No. 4, pp. 305-360.

John, K.; Senbet, L.W. (1998) “Corporate Governance and Board Effectiveness. “ Journal of Banking & Finance, Vol. 22, No. 4, pp. 371-403.

La Porta, R.; Lopes-de-Silanes, F.; Shleifer, A.; Vishny, R. (1999ª) "Investor Protection and Corporate Valuation." National Bureau of Economic Research, Cambridge, Working Paper 7403.

____. (1999b) "Investor Protection: Origins, Consequences, Reform." National Bureau of Economic Research, Cambridge, Working Paper 7428.

Leal, Ricardo P. C. (2000) "Três desafios para as aberturas de capital," Revista da CVM, No. 32, pp. 56-61.

_____; Da Silva, André L. C.; Valadares, Sílvia M. (2000) Ownership, control, and corporate valuation of Brazilian companies. OECD Latin American Corporate Governance Roundtable Proceedings.

_____; Da Silva, André, L. C.; Valadares, Sílvia M. (2001) "Estrutura de controle das companhias brasileiras de capital aberto." Revista de Administração Contemporânea, forthcoming 2001.

Monaco, D.C. (2000) "Corporate Governance in Brazil: a study on 647 open corporations." ISNIE 2000 Proceedings.

Nenova, Tatiana (2001). Control values and changes in corporate law in Brazil. World Bank working paper.

Pinheiro, Armando C.; Cabral, Célia. (1998) Mercado de crédito no Brasil: o papel do judiciário e de outras instituições. Ensaios BNDES 9.

Saito, Richard. (2000) Differential pricing of equity classes, majority control and corporate governance: evidence from the Brazilian equity market. Fundação Getúlio Vargas working paper.

Siffert, N. (1998) "Governança Corporativa: Padrões Internacionais e Evidências Empíricas no Brasil nos Anos 90." Revista do BNDES, Vol. 5, No. 9, pp. 123-146.

Siffert, N.; Silva, C.S. (1999) "As Grandes Empresas nos Anos 90: Respostas Estratégicas a um cenário de Mudanças." BNDES working paper.

Spencer Stuart. (1999) Index Spencer Stuart de Conselhos de Administração.

Valadares, S.M.; Leal, R.P.C. (2000) "Ownership and Control Structure of Brazilian Companies." Abante, Vol. 3, No. 1, pp. 29-56.

Valadares, S. M. Três Ensaios sobre Mercado por Controle no Brasil. Rio de Janeiro, PUC-Rio, Departamento de Economia, Tese de Doutorado, 1998.

Varsano, Ricardo; Pessoa, Elisa; Da Silva, Napoleão; Afonso, José Roberto; Araújo, Erika; Ramundo, Júlio César. Uma Análise Da Carga Tributária Do Brasil. Rio de Janeiro: IPEA, Texto Para Discussão 583, 1998.

Ventura, L.C. (2000) A Composição dos Conselhos de Administração das Empresas de Capital Aberto no Brasil. Working paper available at http://www.lcvco.com.br.