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Corporate Governance in Brazilian Non-Listed Companies: Challenges and Opportunities

*By: Leonardo Viegas, Chairman of the Education Committee
IBGC Brazilian Institute of Corporate Governance*

Summary

This paper describes characteristics of Brazilian Non-listed Companies and the efforts of the Brazilian Institute of Corporate Governance to generate awareness and stimulate the use of good corporate governance practices through effective use of research, communications and training activities especially designed for NLCs.

Non-listed companies in Brazil

According to the market research firm IDC there are about 6,000 companies in Brazil with over 250 employees. Only 120 of those companies are listed and regularly traded on the São Paulo Stock Exchange (Bovespa). Even some of these listed companies, however, could be considered NLCs under OECD's broad definition.

This is the case of some large government-controlled companies in the energy and financial industries, large family-controlled groups and privatized companies under foreign control, because of the small amount of shares that are freely traded. From a corporate governance point of view these companies also "look and feel" like NLCs because boards of directors are appointed essentially by controlling shareholders.

Brazilian NLCs belong roughly to following categories:

- Companies partially or completely under founder/family control
- State-owned and government-controlled companies
- Wholly owned subsidiaries of international corporations.

This paper will focus on family-controlled NLCs with short references to the other categories, which seem to be the subject of separate analysis in other OECD meetings.

- Family-controlled NLCs

The overwhelming majority of NLCs are family-controlled. A significant number of large companies were founded in the 1950's, a period of time where entrepreneurship flourished in Brazil. These companies are now owned and sometimes run by members of the second or third generation. Many experience succession problems in management and ownership. Some large companies are by choice unlisted, but have financial stakeholders (equity and/or creditors) beside their controllers. Professional managers run the more experienced and mature family-controlled NLCs, although the founder/family may continue to play an important governance/shareholder role. In the last 10 years many companies tapped private capital

markets (including private equity) and developed an understanding of what the governance requirements are. Some may soon follow the example of the 8 companies that made highly successful IPOs in the last 12 months. These IPOs were made in the elite segment of the São Paulo Stock Exchange known as Novo Mercado (New Market), a separate listing that requires good corporate governance practices of its listed members. There is a growing understanding among members of these family groups that good corporate governance creates value for the company, reduces disputes between heirs and successors and contributes to the company sustainability in the long run.

- **State-owned and government-controlled companies**

During the 1990s some of the largest government-owned companies in the transportation, chemical, steel, telecommunication and financial industries were privatized and are now under private domestic or foreign control. A significant number of companies are still wholly owned or under control of federal and regional governments. Many are seriously seeking improvements in governance standards in order to improve performance and facilitate access to capital.

- **Wholly owned subsidiaries of international corporations**

International corporations generate a significant part of the Brazilian Gross Domestic Product. Many of these companies are wholly owned subsidiaries of public corporations in their home countries. This is the case of the automobile companies and some utilities. These subsidiaries are known for their poor corporate governance practices such as lack of transparency, non-disclosure of relevant financial information and pro-forma boards of directors.

NLCs and the IBGC Code of Best Practices of Corporate Governance

The IBGC Brazilian Institute of Corporate Governance - is a not-for-profit organization that was founded in 1995 by a group of business people who believed in the power of good corporate governance to create value for corporations and for society as a whole. At that time, corporate governance was a concept vaguely associated with the protection of minority shareholders and good corporate behavior and its Portuguese translation sounded like yet another imported consultant's jargon with little meaning for the business community.

A very important development in the steps taken by the IBGC to spread the ideas of corporate governance in Brazil came with the publication in 1999 of first version of a "Brazilian Code of Best Practices". Using the codes that had already been published around the world as a basic guideline, the Institute's board of directors drew up a comprehensive code adapted to the Brazilian legal framework and business environment.

One big difference from published international codes is that the IBGC considers not just listed companies but also NLCs and even partnerships as a way to broaden its scope. Another difference is that US- and UK-inspired codes of best practices focus mainly the board of directors as the weak link between shareholders and management, whereas the IBGC code involves practices and relationships between owners, the board of directors, the management, the independent auditors and the fiscal council (the fiscal council is a Brazilian specific legal provision to support the rights of minority shareholders). The choice of involving the whole system of governance is due to the prevalence of controlling owner(s) in most Brazilian companies. The IBGC code includes a short, practical definition of corporate governance that demanded extensive discussions in the board. The code was launched with high visibility at the São Paulo Stock Exchange with support of the hosts and of the Brazilian securities and exchange commission (CVM). The code had a strong effect to consolidate and communicate the concept of corporate governance, and became the basis for education programs of the Institute.

Preaching the gospel of good Corporate Governance

Since the very beginning it was realized that the Institute should create events to spark the interest of the business world. Monthly meetings for the members provide an opportunity to discuss corporate governance issues with invited guests: directors, CEOs, investors, lawyers, auditors, consultants and regulators. Sir Adrian Cadbury, guru of the corporate governance world, addressed the members in one of the early events. Another outstanding event brought Ira Millstein to speak at the São Paulo Stock Exchange. Guest speakers and the attendance include representatives of NLCs as well as listed companies; Event subjects often include issues such as succession in property and management of family-controlled companies.

The IBGC holds 1-day annual congresses since year 2000. Panels often include NLC issues, especially family-controlled companies. The founder and president of the Family Business Network, Alden Lank,

spoke at the gala dinner before the first Congress. The 2004 Congress had 380 registered participants. Of the 43 companies represented (not counting service providers such as law-, accounting- and consulting firms), 23 were NLCs. Under the broad definition of NLC in the agenda of this meeting, about 80% of the companies might be considered NLCs.

Training as a means to promote good practices

An early education project consisted in the organization of two weeklong seminars, the first in Boston/New York in 1998 and the second in London/Paris in 1999. A group of 20 business people participated in a series of lectures by Harvard professors, executives and directors of pension funds, stock exchanges and associations.

In 1999 the Institute organized the first course for corporate directors. Lecturers were recruited among the IBGC members; students were attracted among the members' network of companies. It soon became apparent that the majority of attendants belonged to family-controlled NLCs with little knowledge of capital markets and challenges of a global economy. Training programs usually assume a high content of "how to do" disciplines. The needs of the IBGC attendants are in turn more of a conceptual nature with a high content of "what and why" issues. Case studies that exemplify successes and failures help generate empathy and motivation.

Since 1999, about 1500 students participated in the IBGC open enrollment and in-house courses. In 2004 alone they were 578. The student profile of IBGC open enrollment courses is extremely varied and makes the IBGC courses unique. In any class we may find a 20 year-old heir concerned with his first job in the family business, sitting next to the founder of another company concerned with disputes among his grandchildren (the eldest IBGC student was over 80). Some students are seasoned CEOs of international corporations that are close to retirement and think of becoming professional directors. There may be a widow who owns a controlling stake in a large company sitting next to an investment analyst of a pension fund. Some students are young lawyers, auditors and consultants. Others work for NGOs concerned with social and environmental issues. All they have in common is the involvement with governance of their organizations.

In-house courses have a far more homogeneous attendance. The demand consists of tailor made courses for different constituencies. Courses for listed companies are the exception. Most in-house demand comes from NLCs: family groups and government-owned companies. In 2004 there was a strong demand for the training of government officers that act as directors or auditors of companies in which the State has a stake.

As the attendance figures grew the course offerings were adapted to satisfy the needs of different segments. Present programs consist of following courses:

- Director training course is the oldest offering and is presently in its 16th version. It consists of 64 classroom hours and covers concepts, legislation, business and financial strategy, financial statements and ethics.
- Best practices course is a short, 16-hour course that follows essentially the IBGC Code of Best Practices of Corporate Governance.
- Corporate Governance for Family-controlled companies is a 40-hour program similar to the director training program with emphasis on family issues such as family constitution, succession, marriage settlements, testament rules, exit rules, career systems, family council, conflict solving etc.
- Board Case is a role-play course based on a case study, where participants take turns in playing the role of a board member, an audit committee member and a compensation committee. This course is a joint venture between the IBGC, Deloitte and Spencer Stuart.

Following new courses are under development:

- Risk Management and Control is a 2-day course specially designed for members of Audit Committees, Fiscal Councils, Internal and Independent Auditors. It explores Risk Management techniques and the relationships between the board of directors, internal auditors, independent auditors, fiscal council members and management.
- Family Office in family-controlled companies is a compact 3-day workshop designed to explore the separation of family affairs from those of the company. It will describe the functions of a family office as a concierge or investment manager, tax, accounting and estate planning, asset allocation, etc.
- Advanced issues of corporate governance will be half-day seminars about special situations faced by corporate directors such as "Critical problems in the disclosure of financial statements", "Conflict

risks”, Executive compensation”, “Evaluation of merger/acquisition proposals” and “Evaluation of financial transactions”. These courses would function as continued education for those students who participated in basic programs.

Challenges and opportunities for better corporate governance in NLCs

Like in many countries, there is a limited supply of information about NLCs in Brazil, maybe because family-controlled companies are deeply involved with the family itself. Reliable sources such as the Internal Revenue Service and credit information are of course not available. Macroeconomic trends tight fiscal policies and high interest rates are presently inauspicious. Company informality grows along with ever-rising taxation and antiquated labor regulations. And yet there are signs of strength in family-owned NLCs that seem to be aware that they have to rely on themselves for performance and growth. Positive signs are also noticeable in the very different environment of government-controlled NLCs, many of them engaged in programs for the improvement of governance standards in order to access capital markets.

Following opportunities for further development of NLCs are:

- The São Paulo Stock Exchange will launch shortly an “Access Market” with the cooperation of the IBGC. This program will prepare family-controlled NLCs to raise governance standards and eventually tap capital markets.
- IBGC will launch a research project to assess the corporate governance practices of family-controlled companies. This project will be sponsored by CIPE Center for the International Private Enterprise. Research conclusions will be published and create guidelines for the training of shareholders and directors of participating companies. They will also form the basis for a focused training of family-controlled NLCs.
- The IBGC developed talks with the IoD the Institute of Directors of the UK for the improvement of education efforts of directors. In the future this effort may lead to a joint certification of directors.