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# ANALYSIS OF THE RECENT LEGISLATIVE TREND TOWARDS INCREASED REGULATION AND INVESTOR PROTECTION IN THE BRAZILIAN SECURITIES MARKET

*Micah B. Harper\**

## I. INTRODUCTION

**T**HE Brazilian securities market has traditionally been one of the strongest securities markets in South America.<sup>1</sup> Although still considered an emerging market, the Brazilian securities market has undergone a series of legislative changes over the past five years designed to provide increased investor protection through more stringent governmental regulation and enforcement.<sup>2</sup> These legislative changes have strengthened the position of minority shareholders,<sup>3</sup> increased the total portion of share capital necessary to have control of a corporation,<sup>4</sup> placed stricter regulations on independent auditors,<sup>5</sup> proposed an initiative to “[modernize] the accounting approach provided for under the Corporate Act . . . and bring it in line with best international accounting practices (International Accounting Standards – IAS),”<sup>6</sup> and lowered the amount of representation necessary to elect a member to the board of directors of a corporation.<sup>7</sup> To give these new laws the desired effectiveness, they have been combined with more rigorous governmental en-

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1. Euchério Lerner Rodrigues, *Brazil: Macroeconomic Features*, EMERGING MARKETS COMPANION, available at [http://www.emgmks.com/research/brazilian\\_sec/macroeconomic.htm](http://www.emgmks.com/research/brazilian_sec/macroeconomic.htm) (June 1996).

2. CVM Chairman José Luiz Osorio, Global Portfolio Investments: Opportunities and Barriers in Emerging Markets, Presentation Before IOSCO Conference 2002, available at [http://www.cvm.gov.br/ingl/public/publ/Publ\\_Disc\\_IOSCO.asp](http://www.cvm.gov.br/ingl/public/publ/Publ_Disc_IOSCO.asp) (May 2002) [hereinafter IOSCO Speech].

3. Decreto No. 10.303, de 31 de Outubro de, D.O.U., de 11.01.2001, available at <http://www.planalto.gov.br> (last visited Nov. 9, 2003).

4. Nadia Villagomez, *Brazilian Governance: One Step Forward, Two Steps Back*, THE ISS FRIDAY REPORT, Nov. 2001, at 2 [hereinafter ISS FRIDAY REPORT].

5. See CVM Instruction No. 308, available at <http://www.cvm.gov.br> (last visited Nov. 9, 2003).

6. IOSCO Speech, *supra* note 2, at 5; see Proposed Bill No. 3,741.

7. IOSCO Speech, *supra* note 2, at 5.

forcement. “In 2001, [the Brazilian Securities and Exchange Commission] judged 37 administrative inquiries, more than twice the average of 18.2 judgments per year from 1996 to 2000.”<sup>8</sup>

## II. OVERVIEW: SECURITIES AND EXCHANGE COMMISSION OF BRAZIL

The Comissão de Valores Mobiliários (Brazilian Securities and Exchange Commission, CVM) was created in 1947 as “an independent government entity . . . linked to the Ministry of Finance.”<sup>9</sup> Along with the Ministry of Finance, the CVM is charged with the following duties:

1. Stimulate the creation of savings and their investment in securities;
2. Promote the expansion, regular, and efficient operation of the stock market, and stimulate permanent investments in the capital stock of public companies controlled by private Brazilian capital;
3. Guarantee the efficient and correct operation of stock markets and over-the-counter markets;
4. Protect securities holders and market investors against:
  - (a) the irregular issue of securities;
  - (b) illegal acts of officers and controlling shareholders of publicly held companies, or managers of securities portfolios; . . .
5. Avoid or prevent any kind of fraud or manipulation intended to create artificial conditions of supply, demand, or price of the securities traded on the market;
6. Guarantee public access to information on the securities traded and the companies issuing them; [and]
7. Guarantee the observance of equitable business practice on the securities market.<sup>10</sup>

Much like the Securities and Exchange Commission of the United States, the CVM is the governmental entity charged with regulation, oversight, and enforcement of the Brazilian securities markets.<sup>11</sup> Its creation in 1947 began the long process of ending deregulation in Brazilian capital markets and encouraged foreign investment.<sup>12</sup> According to Ary Oswaldo Mattos Filho, CVM president, “the importance of securities market reform in the short term is to make the Brazilian corporate sector more open, and by doing so to restore its credibility.”<sup>13</sup>

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8. *Id.* at 7.

9. Decreto No. 6.385, de 7 de Dezembro de 1976, art. 5, D.O.U. de 7.12.1976, *available at* <http://www.cvm.gov.br> (last visited Nov. 9, 2003).

10. *Id.* at art. 4.

11. *Id.*

12. Clarissa Souza della Nina, *Public Debt Control in Brazil*, INST.OF BRAZ. ISSUES, GEO. WASH. U., Spring 1997, at 2, *available at* <http://www.gwu.edu/~ibi/minerva/Spring1997/Clarissa.Souza.della.Nina.html> (last visited Nov. 9, 2003).

13. Eric Laursen, *Welcome to the Jungle: Brazil's Securities Reform Puts the Muscle on Local Companies*, ASSET INT'L, INC., Sept. 1991, *available at* <http://www.assetpub.com> (last visited Nov. 9, 2003).

### III. KEY LEGISLATIVE ACTIONS OF THE PAST FIVE YEARS

#### A. CVM INSTRUCTION NO. 308 OF 1999

On May 14, 1999, the CVM issued CVM Instruction No. 308, which mainly dealt with independent auditing firms and the audits of publicly held companies.<sup>14</sup> One significant provision of this Instruction requires that all independent auditors appointed after the passage of the legislation be registered with the CVM, which will evaluate their professional capabilities.<sup>15</sup> This provision is an attempt to impose minimum requirements of professional capability on the independent auditing community, and has had a significant impact on the independent auditing community already.<sup>16</sup> Another significant provision initiates a mandatory five-year rotation period for independent auditors of publicly held companies, prohibiting independent auditors from providing auditing services to the same client for more than five consecutive years.<sup>17</sup> This requirement will help minimize the possibility of fraud stemming from a close personal relationship between the auditor and the public company and helps ensure the auditor's objectivity.

Additionally, independent auditors are prohibited from rendering a number of consulting services that "could result in the loss of objectivity and independence."<sup>18</sup> Independent auditors are prohibited from being "a partner, director, or responsible professional who has an employment relationship"<sup>19</sup> with the audited company and are prohibited from owning securities issued by the audited company.<sup>20</sup> These provisions are an obvious attempt to prevent conflicts of interest in the auditor in order to avoid tainting the reliability of audited statements.

Finally, the law requires independent auditors to "implement an internal quality control program . . . which seeks to guarantee full compliance"<sup>21</sup> and to "submit their quality control for review" every four years.<sup>22</sup> This final provision will help alleviate the CVM's daunting task of ensuring compliance and reliability of audited statements on an ongoing basis.

#### B. COMPARISON TO RECENT UNITED STATES LEGISLATION

A brief examination of the Sarbanes-Oxley Act<sup>23</sup> passed by the United States in 2002 puts the significance of these legislative changes into per-

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14. See CVM Instruction No. 308, *supra* note 5.

15. *Id.* at art. 1.

16. See BDO SEIDMAN, LLP, BDO DIRECTA: CMV: BRAZILIAN SECURITIES COMM'N, July 13, 1999, at <http://www.bdo.com.br/audit/ing/txtnews5.htm>.

17. CVM Instruction No. 308, *supra* note 5, at art. 31.

18. *Id.* at art. 23(II).

19. *Id.* at art. 11.

20. *Id.* at art. 23(I).

21. *Id.* at art. 32.

22. *Id.* at art. 33.

23. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 804(a), 116 Stat. 745, 801 (2002).

spective. Unlike Brazil, the United States does not currently require public companies to rotate independent auditors on any set schedule.<sup>24</sup> The Sarbanes-Oxley Act charges the Securities and Exchange Commission with conducting a study to determine the need for a five-year rotation period,<sup>25</sup> which is evidence that Congress believes that such a limitation may have merit. Also, it was not until passage of this Act in 2002 that the United States prohibited independent auditors from performing a majority of consulting services for their clients, a full three years after the parallel prohibition in Brazil.<sup>26</sup> The United States' adoption of these practices serves as a kind of ratification of the CVM's efforts under this Instruction.

### C. CORPORATE GOVERNANCE BILL OF 2001

Enacted on November 1, 2001, Brazil's Corporate Governance Bill made a number of changes to the existing securities regulation landscape.<sup>27</sup> One of the most significant changes was the increased protection afforded minority shareholders.<sup>28</sup> The primary protections granted to minority shareholders under this act are "tag-along" rights relating to the transfer of control of a publicly held company.<sup>29</sup> As proposed, the law would have required the purchaser to offer minority shareholders 100 percent of the amount paid for the controlling block of shares.<sup>30</sup> As passed, the law requires the purchaser to "conduct a public offer to acquire the voting shares owned by the remaining [minority] shareholders. The offer price for such shares shall be at least [80 percent] of the amount paid for the voting shares comprising the controlling block."<sup>31</sup> The likely objective of these added protections for minority shareholders is to encourage investor confidence with respect to equity positions that are less than controlling and are, by their nature, subject to the decisions of majority shareholders. Although still not an ideal solution for investors, "its passage carries with it the message that Brazil does not turn a deaf ear to the plight of minority shareholders."<sup>32</sup>

Additionally, "where companies were previously permitted to have two-thirds of issued capital in nonvoting preference shares and one-third in voting common shares, the new law limits the number of preference shares to 50 percent of the share capital."<sup>33</sup> The effect of this change is that "the total portion of share capital necessary to have control increases to 26 percent" from the previous requirement of 17 percent.<sup>34</sup> It also

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24. *See id.* § 203.

25. *Id.* § 207.

26. *Id.* § 201.

27. IOSCO Speech, *supra* note 2, at 5.

28. Decreto No. 10.303, *supra* note 3.

29. *Id.*

30. ISS FRIDAY REPORT, *supra* note 4, at 2.

31. Decreto No. 10.303, *supra* note 3.

32. ISS FRIDAY REPORT, *supra* note 4, at 2.

33. *Id.*

34. *Id.*

forces those shareholders who control the corporation to have a larger percent of ownership, and therefore a larger stake with respect to the ramifications of their decisions. This more closely aligns their interests with those of minority shareholders.

Finally, this new piece of legislation lowers the percentage of common stock necessary to elect a member to the board of directors from 20 percent to 15 percent.<sup>35</sup> This lowers the threshold of ownership necessary to ensure direct representation of minority shareholders with respect to management of the company and its operating decisions. Where in the past minority shareholders of voting stock of less than 20 percent were without direct representation and thus at the mercy of the majority shareholders, now minority shareholders with at least a 15 percent voting equity position have a directly elected voice in the management of the company's affairs.

#### D. LAW 10,411 OF FEBRUARY 2002

The CVM underwent a fundamental evolution of form in 2002 when it was granted "independent administrative authority, fixed terms of office and stability for its directors."<sup>36</sup> Although tied to the Ministry of Finance, "the [CVM] does not report to the Ministry. It [now has] the authority to oversee the derivatives market and will be able to investigate and – most importantly – enforce breaches or irregularities in the securities market."<sup>37</sup> The effect of this evolution was to insulate the CVM and its management from the political pressures typically associated with being a governmental entity. Pursuant to this new law, the CVM enjoys a direct grant of authority, and its director's terms are no longer subject to shifting political agendas.

#### E. PROPOSED BILL NO. 3,741

Proposed Bill No. 3,741, legislation that would adopt International Accounting Standards (IAS), is currently pending before the Brazilian Congress. Passage of this bill would "contribute to the harmonization of this legal framework and bring it in line with best international accounting practices."<sup>38</sup> Currently, Brazil uses its own set of national accounting practices.<sup>39</sup> By adopting IAS, corporate financial statements would become more transparent to international investors and give those investors a greater sense of confidence with respect to their investments.<sup>40</sup> According to CVM Chairman José Luiz Osorio, "the initiative is particularly important and necessary in a world where cross-border investments are a vital force behind the development of all nations."<sup>41</sup>

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35. IOSCO Speech, *supra* note 2, at 5.

36. *Id.*

37. ISS FRIDAY REPORT, *supra* note 4, at 2.

38. IOSCO Speech, *supra* note 2, at 5; see Proposed Bill No. 3,741, *supra* note 6.

39. CVM Instruction No. 308, *supra* note 5, at arts. 20-21.

40. IOSCO Speech, *supra* note 2, at 5.

41. *Id.*

## IV. CONCLUSION

The Brazilian legislative actions of the past five years have been aimed at providing increased investor protection through more stringent governmental regulation and enforcement. By enacting regulations to protect minority shareholders, the CVM has given investors more confidence that their interests will still be represented when taking minority positions. The regulation of independent auditors allows investors to rely more heavily on audited statements when making investing decisions, not having to be concerned that the statements are subject to undisclosed conflicts of interest or incompetent auditing abilities. The proposal to shift accounting principles to comply with IAS allows international investors to read financial statements more easily and encourages their investment in the Brazilian marketplace. All of these legislative initiatives, taken together, have the effect of strengthening the Brazilian securities market and encouraging investment. Although still a work in progress, the securities market in Brazil is on its way to becoming a stable and open marketplace.