

5

FOCUS

Novo Mercado and Its Followers: Case Studies in Corporate Governance Reform

Maria Helena Santana

Melsa Ararat

Petra Alexandru

B. Burcin Yurtoglu

Mauro Rodrigues da Cunha



Global
Corporate
Governance
Forum



Copyright 2008.
International Finance Corporation
2121 Pennsylvania Avenue, NW
Washington, DC 20433

All rights reserved.

The findings, interpretations, and conclusions expressed in this publication should not be attributed in any manner to the International Finance Corporation, to its affiliated organizations, or to members of its board of Executive Directors or the countries they represent. The International Finance Corporation does not guarantee the data included in this publication and accepts no responsibility for any consequence of their use.

The material in this work is protected by copyright. Copying and/or transmitting portions or all of this work may be a violation of applicable law. The International Finance Corporation encourages dissemination of its work and hereby grants permission to the user of this work to copy portions for their personal, noncommercial use, without any right to resell, redistribute, or create derivative works there from. Any other copying or use of this work requires the express written permission of the International Finance Corporation.

For permission to photocopy or reprint, please send a request with complete information to:

The International Finance Corporation
c/o the World Bank Permissions Desk
Office of the Publisher
1818 H Street NW
Washington, DC 20433

All queries on rights and licenses including subsidiary rights should be addressed to:

The International Finance Corporation
c/o the Office of the Publisher
World Bank
1818 H Street, NW
Washington, DC 20433
Fax: +1 202-522-2422

Novo Mercado and Its Followers: Case Studies in Corporate Governance Reform

Maria Helena Santana

Melsa Ararat

Petra Alexandru

B. Burcin Yurtoglu

Foreword by Mauro Rodrigues da Cunha

Global Corporate Governance Forum

Focus 5

ACKNOWLEDGMENTS

The Global Corporate Governance Forum would like to extend its sincerest thanks to Maria Helena Santana and the BOVESPA for their contributions to, and support for, this publication. The Forum is fortunate to have had the opportunity to document in this publication the “great experiment” of BOVESPA and its members and to recount the initial impact of this pro-active corporate governance leadership experience, both regionally and globally. We are grateful, too, for the efforts of the other contributors to this edition of *Focus*, Melsa Ararat, Petra Alexandru, B. Burcin Yurtoglu, and Mauro Rodrigues da Cunha. Their analyses helped us to discern the lessons of Novo Mercado and its followers, specifically the stock exchanges in Bucharest and Istanbul. The Forum also thanks Mike Lubrano, formerly IFC Manager of the Investor and Corporate Practice Unit, and now Managing Director, Corporate Governance at Cartica Capital, LLC. Mr. Lubrano dedicated time and effort in reviewing and commenting on the earliest versions of this manuscript. His first-hand experience with the Novo Mercado, and his longstanding corporate governance investment career have both benefited this document, and in turn, the Forum and its readership. Nancy Metzger, senior projects officer at the Forum, worked with the authors, translators, and editor to develop this publication so that its insights were practical, relevant, and compelling. Finally, this publication would not have been possible without the professional diligence and skill of an outstanding editor—James Spellman. We thank him for his meticulous attention to detail, his insightful suggestions and edits, and his general good spirit throughout this year-long project involving so many.

CONTENTS

Acknowledgments.....	ii
About the Authors	v
Praise for Novo Mercado	vii
Foreword by Mauro Rodrigues da Cunha , CFA	ix
The Novo Mercado by Maria Helena Santana	
1. Context.....	2
2. The Novo Mercado and Corporate Governance Levels 1 and 2.....	12
3. Implementation	16
4. Initial Results.....	22
5. The Dramatic Change, The Consolidation	22
6. Highlights.....	24
7. The Impact of Governance Rules on Prices	31
8. Challenges.....	32
Corporate Governance Reform Activities in Brazil and IFC support. Timeline of Events through 2006	37
Novo Mercado Versus Romania’s Transparency Plus Tier—A Mirror Image? by Petra Alexandru	
1. Introduction	41
2. Environment	42
3. The Main Problems.....	42
4. The Transparency Plus Tier and the BVB Corporate Governance Code ...	45
5. Romania’s Successes and Failures with Transparency Plus Tier	51
6. Where We Are—Some Perspectives	53
Learn More Online	54

CONTENTS (CONTINUED)

Rating-Based Indexing of the Istanbul Stock Exchange:
Lessons from Novo Mercado’s Success to Advance Corporate
Governance Reforms by **Melsa Ararat** Ph.D. and **B. Burcin Yurtoglu** Ph.D.

1. Introduction	57
2. Brazil and Turkey: Their Economies, Financial Markets	58
3. Ownership Patterns: Differences, Similarities in Two Periods— The 1990s and 2000-2006	63
4. Changes after 2000: Novo Mercado—Why or Why Not?	67
5. Reflections on The Drivers Of Reform: The Corporate Governance Index Experience and Its Outlook.....	72
Learn More Online	75
References	77

ABOUT THE AUTHORS

Mauro Rodrigues da Cunha, CFA joined the Mauá Investimentos team in July 2007 as Partner and Head of Equities. Previously, he was the Chief Investment Officer at Franklin Templeton Investimentos Brasil, and its predecessor Bradesco Templeton (2001–2007). Prior to that, he held a variety of positions in the financial services sector in Brazil. A Chartered Financial Analyst, Cunha earned an MBA from the University of Chicago Graduate School of Business and a BA in Economics from Pontifícia Universidade Católica do Rio de Janeiro. He has participated in the boards of several publicly traded companies in Brazil and has been an active participant in the debate to reform Brazilian corporate law and capital markets regulations. These efforts include the Latin American Corporate Governance Roundtable, co-sponsored by the IFC, with support from its Global Corporate Governance Forum, and the OECD. He is currently vice-chairman of the board at the Instituto Brasileiro de Governança Corporativa (IBGC) and a lecturer in the institute's corporate governance courses. Cunha has participated in the Forum's Corporate Governance Leadership Program, held at the World Bank's headquarters, and other international events.

Maria Helena Santana became chairperson of the Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários) in July 2007, after serving as a commissioner for one year. Before then, she worked for the São Paulo Stock Exchange (BOVESPA), starting there in 1994. Between 2000 and June 2006, she was the Listings and Issuer Relations Executive Officer. In this role, she was responsible for both the supervision of listed companies and new listings. She was in charge of the creation and implementation of the Novo Mercado and the Corporate Governance Levels.

Petra Alexandru is an executive manager with the Bucharest Stock Exchange (BVB) in Romania. She worked with the National Securities Commission of Romania until 1998, when she joined the BVB as a Deputy General Manager. She has been a member of two OECD Working Groups, one on “Capital Markets Development” and the other on “Corporate Governance in SEE Countries.” She has made contributions to adopting the “OECD Best Practices for the Development of Stock Exchanges in Transition Economies” and the “OECD White Paper on the Corporate Governance in Southeast Europe.” She also closely worked with East-West Management Institute—Partners for Financial Stability Program in Warsaw on corporate governance issues. Ms. Alexandru is one of the promoters of corporate governance principles in Romania and is deeply involved in the creation of the Bucharest Stock Exchange Corporate Governance Institute. Ms. Alexandru has a degree in International Business from the Academy of Economic Studies, Bucharest and post-university studies in capital markets.

Melsa Ararat, Ph.D. is the director of the Corporate Governance Forum of Turkey (CGFT), a research center hosted by Sabanci University in Istanbul. Following a career in international management, she has been active since 2000 in developing capacity for corporate governance research and education in Turkey in cooperation with international governance research and advocacy networks. Ararat is also on the faculty of Sabanci University's Business School, lecturing in strategic management, ethics in business, and corporate governance. Her responsibilities include coordinating the Global Corporate Governance Forum's Research Network, which she has done since 2007. Ararat was a member of Turkey's Capital Markets Board, which developed the Corporate Governance Guidelines for listed companies.

B. Burcin Yurtoglu, Ph.D. is a professor with the Department of Economics at the University of Vienna. His other affiliations include: research associate at the ESRC Centre for Business Research, Judge Institute of Management Studies, University of Cambridge; member of the Country Team Austria with the European Corporate Governance Institute; and, a member of the network faculty of the Graduate School of Management of Sabanci University.

PRAISE FOR NOVO MERCADO

“If other Latin American companies come to Brazil, they will most likely list on the BOVESPA’s Novo Mercado, a mechanism with stringent listing and corporate governance requirements.

“The Novo Mercado has attracted a growing number of companies, from just one in 2002 to 52 so far this year as more and more publicly listed firms migrate to the Novo Mercado from lower level listing and investors increasingly flock to companies offering the greater protections to minority shareholders.”

Dow Jones Newswires, March 26, 2007

“The value paid in dividends by openly traded companies reached R\$22.3 billion (US\$10.6 billion) and entered the list of records accumulated by the São Paulo Stock Exchange BOVESPA in 2006. [These numbers] reflect the strong profitability of companies. But not just this. There is a trend to improve the dividend policy as part of good corporate governance practices. Adopting them, they qualify to receive a portion of the international liquidity that is coming to the emerging market countries.”

Gazeta Mercantil, March 12, 2007

“Brazil is attracting overseas investors by playing their game. The Novo Mercado, a new stock market whose corporate governance rules mirror those of the United States and Europe, almost doubled its listings in 2006. An index of companies that follow the regulations has outperformed the benchmark BOVESPA index in the past 12 months.

“‘It went from water to wine,’ said Wagner Pinheiro, president of Petros, a Brazilian pension fund. He said he doubled his stock holdings over the past four years.”

International Herald Tribune, March 8, 2007

“Brazil’s receding riskiness and a global abundance of liquidity have narrowed the difference in yields between Brazilian and American bonds to less than two percentage points. . . . The economy may be trotting, but credit, property, and the stock market are off at a gallop.”

The Economist, April 14, 2007

“The Novo Mercado has the most rigorous corporate governance rules on the BOVESPA.”

Dow Jones Newswires, August 20, 2007

“It took a while to catch on, but Brazil’s Novo Mercado is now roaring—and showing a global path to value. Last night, a celebration in São Paulo marked the 100th company to join BOVESPA trading board reserved for corporations voluntarily reaching the highest requirements of corporate governance and transparency. Back in 2001, founders argued that the route to market growth was through a high accountability index rather than a high tech index. They were right.”

Global Proxy Watch, March 2, 2007

“Our recent experience in the Brazilian IPO market...is not only of a robust alternative asset class, but also of a model where self-regulation and corporate governance are converging.”

Financial Times, September 26, 2007

“[T]he IPO activity has been good for corporate governance. In order to attract interest, the recent IPOs have had to sign up to so-called Novo Mercado guidelines, which do away with the dual share classes, over-friendly board members and non-existent protection for minority shareholders that made life hazardous for outside investors.”

The Economist, October 27, 2007

“Observers praise BOVESPA for boosting interest in Brazil’s stocks. In 2002, it introduced the Novo Mercado, a listing for newly public companies with U.S.-style corporate-governance standards. Partly as a result, foreign investors have bought up 74% of shares in new listings.”

The Wall Street Journal, October 25, 2007

“Shares of the BOVESPA stock exchange skyrocketed Friday in their trading debut after setting a Brazilian initial public offering record, drawing hordes of foreign buyers who flooded Brazil with dollars and sent the nation’s currency up sharply against the greenback.”

Associated Press, October 26, 2007

“Bovespa Holding SA, owner of the São Paulo stock exchange, surged 52 percent on its first day of trading in Brazil, on prospects Latin America’s fastest growing market will keep expanding after trading jumped sixfold since 2000.

“The company gained 11.99 *reals* to 34.99 *reals* a share, surging past Dubai Financial Market as the most valuable emerging market exchange, with a market capitalization of \$13.95 billion. The initial public offering raised \$3.7 billion this week, making it the fifth-biggest in the world this year.”

Bloomberg, October 26, 2007

FOREWORD

by Mauro Rodrigues da Cunha

It was an interesting sight. On an August afternoon in 2000, dozens of market participants gathered at an unlikely place, the floor of Brazil's Chamber of Deputies. They had come a long way to be there. They all had decided it was worth investing their scarcest resource—time—to offer counsel on overhauling the country's securities laws. As they took their turns speaking at the public hearing, each outlined reasons why it was so urgent to reform these laws.

Brazil's securities market—especially its equities market—was becoming increasingly irrelevant. In previous years, virtually no new companies had tapped the equity market. No initial public offerings. No secondary offerings. In other words, no money was flowing from private savings into the productive sector. Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários, CVM) data suggests close to R\$10 billion was raised in equity offerings between 1995 and 1999—a low number to start with (during the same period, the US IPO market raised US\$324 billion). However, if only public offerings in *reals* are included, the value of equity offerings shrinks to US\$550 million. That was nothing.

The improbable visitors to Brasilia were convinced that their country could and should have a fully functioning world-class equities market. They did not believe that “stratospheric interest rates” were the sole culprit. They understood that demand for shares did not meet supply because of an additional factor that is not usually included in portfolio theory: the risk of fraud.

The legislation that passed one year after their excursion was clearly not the panacea for all the evils, as some had hoped. The “sausage factory” legislative process inherent to democracies turned a well-intentioned project into a mixture of good and bad reforms. Some issues were addressed appropriately. Loopholes were closed, but many others were opened. Intense lobbying from special interests resulted in legislation that only went half as far as was necessary.

As Vice President Marco Maciel approved the new law, market participants greeted the event with a fraction of the enthusiasm they had originally expressed in their testimony. Law 10.303 would not revive the market—not by itself.

Fast forward to early 2007. Analysts predicted that 60 new companies would list their shares on the São Paulo Stock Exchange (BOVESPA). IPO activity was predicted to dwarf the previous year's record of US\$14 billion. Something right must have happened, yes?

While Brazilians are accustomed to decisions coming from the top, Novo Mercado rose from the bottom. BOVESPA consulted with market participants, discussing alternatives and forging effective solutions.

As it turned out, the reforms were not an end in themselves, but rather a means. These efforts forged support for addressing investor concerns about expropriation.

No one captured the gist of the moment as precisely as BOVESPA. Rarely in our history has a century-old institution been as able to understand the dynamics and react accordingly, doing so by “thinking outside the box.”

The history of the Novo Mercado is one of vision, leadership, and perseverance.

BOVESPA Chairman Alfredo Rizkallah, Gilberto Mifano, the CEO, and Maria Helena Santana, the Listings and Issuer Relations Executive Officer at BOVESPA, initiated the process that led to Novo Mercado's creation. From the initial assessment to the final model, Ms. Santana's team fostered the creation of that consensus and channeled its energy into developing new solutions. While Brazilians are accustomed to decisions coming from the top, Novo Mercado rose from the bottom. BOVESPA consulted with market participants, discussing alternatives and forging effective solutions. It was a democratic process. Without such diverse input, the Novo Mercado would probably not be as strong as it is today.

But vision alone wasn't enough to change the market's dynamics. Endurance was also key. In its first years of existence, the Novo Mercado was bombarded by criticism. Some believed that the only solution was the imposition of heavy-handed legal reforms to solve the market's problems. Critics also saw Novo Mercado's standards as unachievable given the realities of Brazilian companies. In their view, the bar had been raised far too high.

But BOVESPA pressed on. Year after year, it resisted pressures to either change the system or scrap it altogether. The Listed Companies Department, led by Ms. Santana, visited companies and investors to showcase the model and defend its merits.

Slowly, their efforts paid off. CCR listed its shares on the Novo Mercado on January 2002. A few months later, Marcopolo listed on Level 2, albeit amid political turmoil. By the time that Natura launched its IPO in June 2004, Novo Mercado was an idea whose time had finally arrived.

In 2007, we celebrated the one-hundredth company that listed on either the Novo Mercado or one of the special listing segments (Levels 1 and 2). We see a future full of hope and opportunities.

To be sure, we are in the early chapters of Novo Mercado. But year after year, BOVESPA breaks new records in stock issuance. More and more companies are getting access to precious capital and growing rapidly, generating dividends and jobs. More and more companies understand what is expected from them by investors – not only a sound business model, but also engaging new shareholders as true partners, treating them with equity, being transparent in governance, and abiding by the highest ethical standards.

Even if future years are not as successful as the recent past, it is very unlikely that Brazil will revert to the conditions that shut down the primary equity markets in the 1990s. Now, we know the drill. A healthy market develops through the natural flow of demand and supply under an effective, competent, and rigorous regulatory framework. Artificial incentives, as we saw before, create imbalances that eventually take their toll. Buyer and seller should be able to meet in the market with minimum distortions. With that, stable rules, and rigorous enforcement, a healthy market should prevail.

Challenges remain, however. While we know the direction is towards progress, we must sustain the pace of reform to ensure long-term growth of Brazil's capital

BOVESPA pressed on. Year after year, it resisted pressures to either change the system or scrap it altogether. Slowly, their efforts paid off.... Today, we see a future full of hope and opportunities.

markets. There were many pitfalls in the development of Novo Mercado. Some are very clear. Others are more complicated, less readily understood. These pitfalls must be addressed, or we risk losing momentum.

More and more companies understand what is expected from them by investors – not only a sound business model, but also engaging new shareholders as true partners, treating them with equity, being transparent in governance, and abiding by the highest ethical standards.

Many reforms still need to stand the test of time. One of these is the Arbitration Chamber. That forum's lack of cases and, hence, decisions has been seen as an obstacle to growth in Brazil's capital market. True, the lack of cases tried by the chamber reduces fears of bad-faith litigation, given its lower-cost adjudication. But this body needs to build a reputation, which will only come over time through use by investors.

The CVM's new powers have yet to be tested. Jailing the first person for insider trading, which has been elevated from a felony to a crime, will be an important development. In order for that to happen, though, CVM may need access to trading data currently protected by bank secrecy laws.

The rights and liabilities of both managers and board members are also under development. Only after this process is completed will board members and managers be held fully accountable for their adherence to the duty of care, duty of loyalty, independence, and fiduciary responsibilities. Until that happens, we are bound to continue seeing: ineffective boards filled with "hot shots" who have no idea of their duties to shareholders; superficial individuals more focused on the "cafezinho" than on the company's business; or, political appointees who seek to supplement their monthly income and want to pursue agendas that are not necessarily aligned with those of the shareholders.

As always, BOVESPA must balance the market's changing needs with the necessity for stable rules. The Novo Mercado has reform mechanisms, but these are purposely hard to use. In some cases, though, improvements are needed. For example, a company should not be allowed to list in a segment that requires high standards of corporate governance if it does not disclose the identity of significant shareholders (the ultimate owners) when they are foreigners.

Some have suggested the creation of a listings board, which would filter out companies that aren't qualified to list on the Novo Mercado. This would allow a departure from the "checklist" approach, which has proved disastrous in foreign experiences. It may be a welcome development. However, it must take into account a clear limit. BOVESPA should not be seen as a "guarantor" of listed companies, thus replacing the need for investor due diligence. One should not try to revoke the law of *caveat emptor* ("buyer beware").

BOVESPA should not be seen as a 'guarantor' of listed companies, thus replacing the need for investor due diligence.

This brings us to another challenge: investor education. BOVESPA and the CVM have assumed responsibility for these activities. Their work must continue. Unfortunately, many "investors" still see the equity market as a casino and are happy to play it as long as the slot machine churns out jackpots. The challenge is to make investors understand the concepts of risk and return, as well as the role of equities in both a diversified portfolio and their long-term savings plans (including retirement). Careful attention to bylaws and shareholder rights cannot be stressed enough.

New bylaws include "defense clauses," which are new to our market. These "poison pills" must be rethought. One must not allow such rules to legitimize non-voting shares that have been so bad for our market or have entrenched management to the shareholders' detriment.

The Novo Mercado has allowed the birth of widely held public corporations without a controlling shareholder. Whether this is an anomaly or an evolution of the Brazilian corporate model, only time will tell. But if the latter is a possibility, market participants must debate the regulatory framework for this new "offspring." Our legislation has always started from the premise that there is a controlling shareholder. The absence of such a shareholder may trigger problems, as the board of the company Lojas Renner SA has

The Novo Mercado has allowed the birth of widely held public corporations. Whether this is an anomaly or an evolution of the Brazilian corporate model, only time will tell.

already noticed. Here, we should rely on the lessons learned in creating the Novo Mercado and build a consensus around the best way to implement further reforms.

Last, but not least, we also face the challenge of broadening mid-sized companies' access to our capital markets. They may be the fastest-growing enterprises, generating most of the new jobs in Brazil's economy, but they still may not have the ability to tap public markets for capital. Here, again, BOVESPA is demonstrating its

We also face the challenge of broadening mid-sized companies' access to our capital markets. These may be the fastest-growing enterprises, which generate most of the new jobs in Brazil's economy, but they still may not have the ability to tap public markets for capital. Here, again, BOVESPA is demonstrating its vision, with the creation of the BOVESPA MAIS.

vision with the creation of the BOVESPA MAIS. It is impossible not to compare this endeavor with the tough early stages of the Novo Mercado. Let us hope that it succeeds. The economic impact of this segment could prove to be even greater than that of the Novo Mercado, given the sheer number of companies that could potentially list their shares on BOVESPA MAIS.

With those words of hope, I leave you with the history of the Novo Mercado, as written by the most qualified person on this subject, Ms. Santana. Her ability to listen, act, and lead was critical to the Novo Mercado's development, a story that we now know has a very happy outcome.



Mauro Rodrigues da Cunha, CFA

Partner and Head of Equities

Mauá Investimentos, Brasil

THE NOVO MERCADO

by Maria Helena Santana

ABSTRACT

The basic premise guiding the creation in December 2000 of the Novo Mercado* (a special segment of the São Paulo Stock Exchange [BOVESPA] available to companies that commit to adopting high standards of corporate governance) was that a reduction in investor perceptions of risk would have a positive effect on share values and liquidity. BOVESPA believed that investors would perceive their risks to be lower if two things occurred: they were granted additional rights and guarantees as shareholders; and, if the asymmetry of access to information between controlling shareholders/company management and market participants was narrowed (if not eliminated). Companies listed on the Novo Mercado voluntarily adopted corporate governance practices beyond those required by Brazilian law, including rules expanding shareholder rights and mandating more comprehensive disclosures. These companies could only issue common, not preferred, stock. Two intermediate segments (Level 1 and Level 2) between the traditional BOVESPA market and the Novo Mercado were established to serve as stepping stones and facilitate gradual adaptation by companies when direct migration to the top level was not considered feasible. Many bet against BOVESPA achieving good results, believing that its proposals were too bold. BOVESPA targeted key market participants and worked to change the business community's culture, counteracting the skepticism to build decisive support. Its survival depended on market forces: Novo Mercado could only become a reality if investors and other suppliers of capital demanded corporate governance reforms and the companies themselves saw these obligations as advantageous. From the first listing, Novo Mercado quickly became the standard that investors would require for new companies going public. Maria Helena Santana attributes the success partly to "the network of partnerships—and concrete initiatives—involving the public and private sectors. . . . These partnerships are very useful in pointing out public and private policy alternatives to help initiatives that depend on market forces flourishing—even under unfavorable market conditions or in countries where the capital market is not yet sufficiently developed." Foreign investors were attracted, and companies issued more secondary offerings. Studies show that an index of Novo Mercado companies outperformed the BOVESPA index. As of the end of June 2006, 31 companies were listed on the Novo Mercado, 13 in Level 2, and 34 in Level 1, representing 52.99 percent of market capitalization and 53.85 percent of share volume traded. In October 2007, the stock exchange

Editor's note: Original draft June 2006
* New Market

went public; its market capitalization became the largest among all emerging market countries. As *The Wall Street Journal* reported, “Observers praise BOVESPA for boosting interest in Brazil’s stocks. In 2002, it introduced the Novo Mercado, a listing for newly public companies with U.S.-style corporate-governance standards. Partly as a result, foreign investors have bought up 74% of shares in new listings.”¹

1. CONTEXT

1.1 *The Environment*

At the end of the 1990s, Brazil’s capital markets were less developed and representative of the country’s economy, and it was facing devastating times.

The issuance of bonds or stocks by Brazilian companies had never reached significant levels as a proportion of the country’s Gross Domestic Product (Chart 1). As a rule, that kind of capital had come from either re-investment of equity profits or from credit obtained from the Brazilian Development Bank (BNDES), which was practically the only source of long-term financing for businesses in Brazil at that time.

Spurred by the prospect that large, state-owned companies would be privatized, Brazil’s capital markets received a significant influx of foreign portfolio investment in the early 1990s. But the higher level of trading volume on Brazil’s stock exchanges

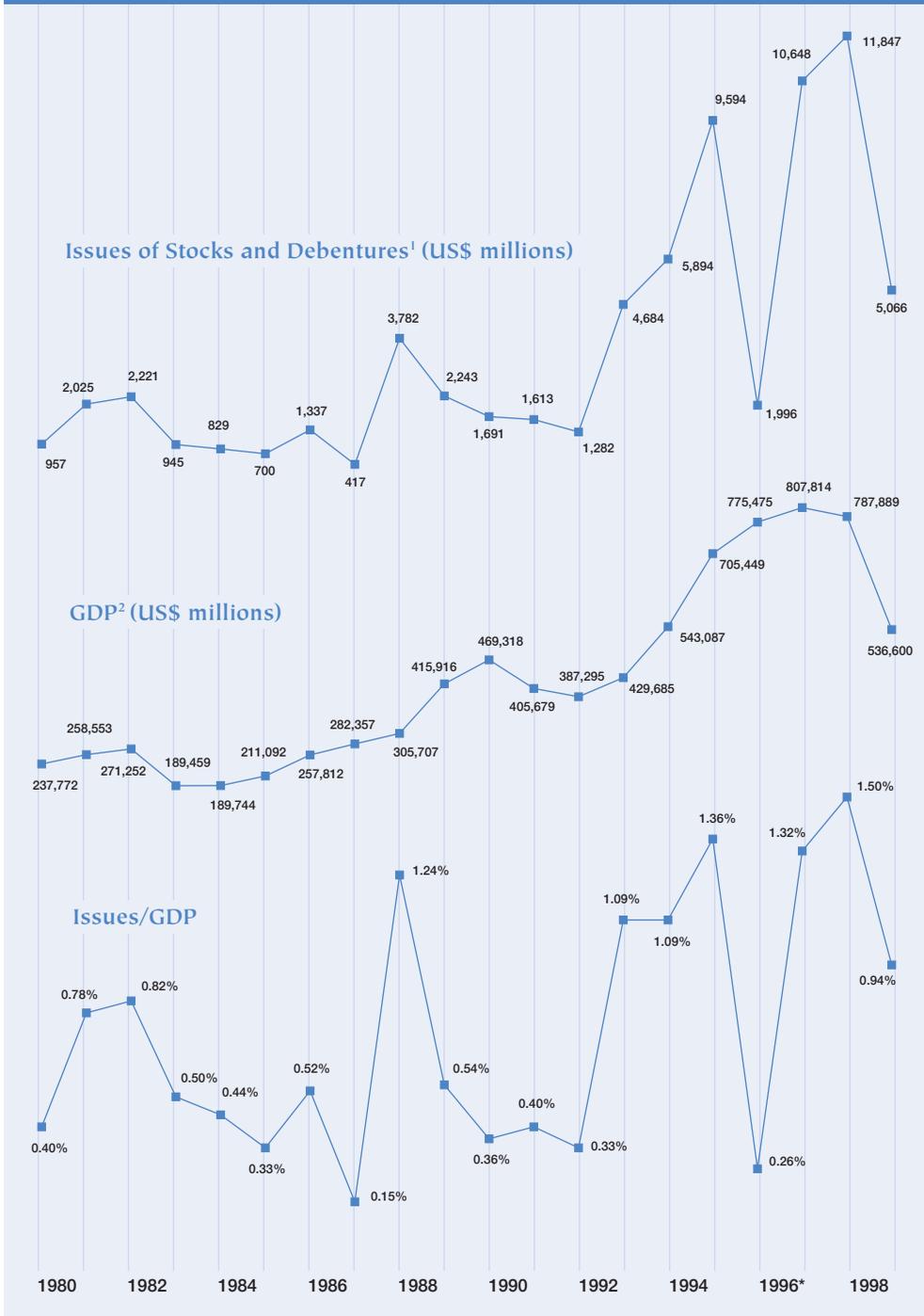
did not prove sustainable during successive crises in the emerging markets generally and in Brazil specifically, especially after mid-1997.

Brazilian companies had no alternative but to “rent” the credibility and depth of another better-regarded market if they wanted to gain access to capital by issuing shares. A large part of the Brazilian market’s liquidity had already been exported to the American exchanges by the late 1990s.

As can be seen from the figures presented in Chart 2, compared to July 1997, the value of shares traded on the BOVESPA declined by 46.76 percent at the end of 2000. Furthermore, share prices dropped sharply: 34.32 percent between July 1997 and December 2000. This is reflected in the performance of the Ibovespa, the index that measures the behavior of the most liquid stocks on the Brazilian market (Chart 3).

¹ *The Wall Street Journal*, October 25, 2007.

Chart 1: Issues of Stocks and Debentures; GDP (US\$ millions), 1980–1988

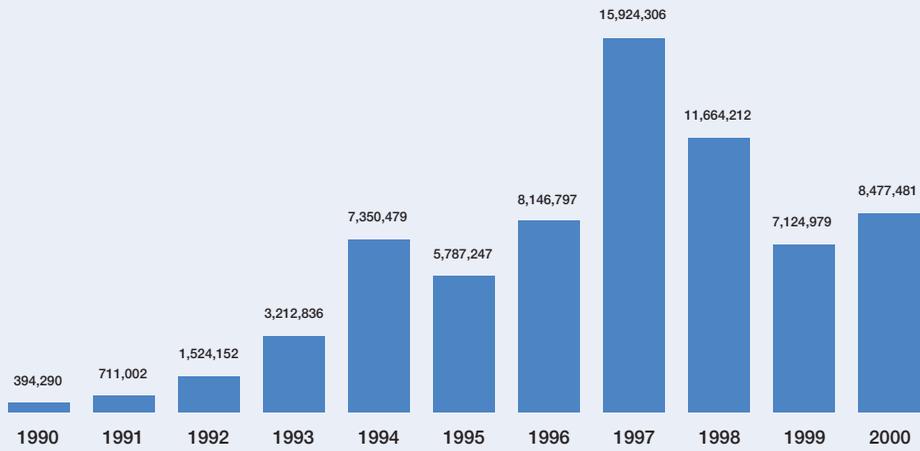


Sources: (1) Brazilian Securities and Exchange Commission (CVM).

(2) Institute of Applied Economic Research (IPEA)

* A US\$8,029.59 million issue by Banco do Brasil was not included, since it was not truly a public offering.

Chart 2: Monthly Traded Value (US\$ thousands), 1990–2000



Source: BOVESPA

Available at: <http://www.bovespa.com.br/indexi.asp>

Chart 3: Trend in the Ibovespa, 1990–2000



Source: BOVESPA

Available at: <http://www.bovespa.com.br/indexi.asp>

UPDATE TO THE EDITOR'S NOTE: ABOUT BOVESPA

The São Paulo Stock Exchange – BOVESPA is the only stock exchange in Brazil and the largest in Latin America, accounting for more than 70 percent of the region's trade volume. BOVESPA's trading value increased 100.3% in 2007 compared to 2006 and reached R\$1.2 trillion (or US\$625.9 billion).

Established in August 23, 1890 on Rua 15 de Novembro, BOVESPA and other Brazilian exchanges were official entities linked to the finance departments of state governments until the enactment of the Securities Act in 1965 when the Brazilian financial system and capital market underwent a series of reforms turning BOVESPA into a non-profit civil association. The benchmark indicator of BOVESPA is the Bovespa Index (IBovespa) which is the main indicator of the Brazilian stock market's average performance.

On BOVESPA, preferred stock ("preferencial nominativa" in Portuguese, or PN) is sometimes the most-traded

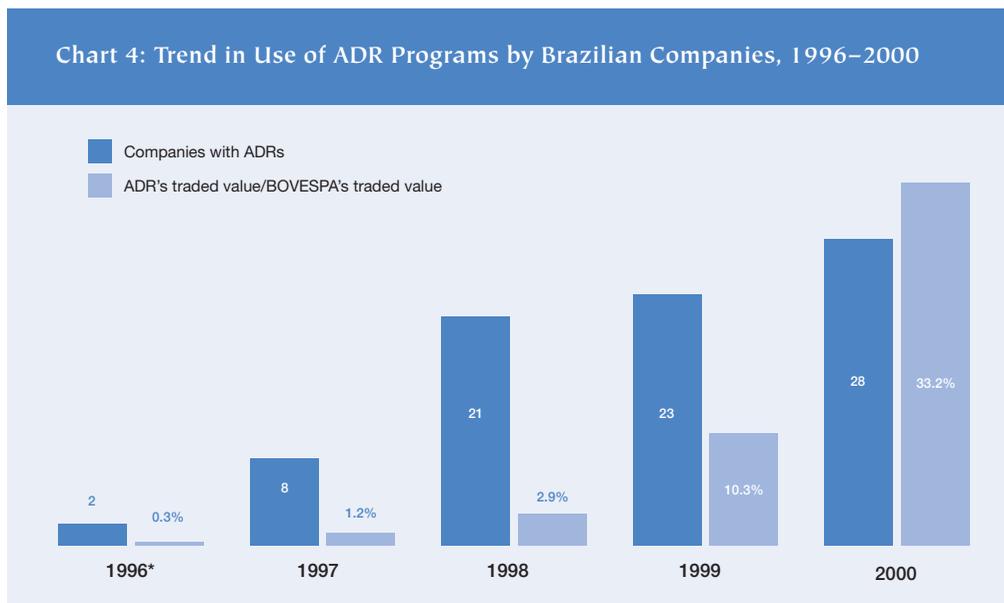
class of stock for a particular company, although common stock ("ordinária nominativa" in Portuguese, or ON) is also traded. The number of companies traded at BOVESPA is 449, and is close to 550 including over the counter, according to the BOVESPA website.

In October, Bovespa Holding SA, as the owner of the São Paulo Stock Exchange, launched an IPO. On the first day of trading, the company's market capitalization reached \$13.90 billion, exceeding the Dubai Financial Market as the most valuable emerging market exchange. The IPO raised \$3.7 billion, making it the fifth biggest in the world in 2007, according to Bloomberg.

In 2007, BOVESPA's market capitalization amounted to R\$2.5 trillion (US\$1.4 trillion), a 60.4-percent increase over 2006. In 2007, the top five sectors in terms of market capitalization were: financial institutions with R\$474 billion (19.1%); oil, gas and biofuel with R\$437 billion (17.6%); mining with R\$292 billion (11.8%); electric power with R\$182 billion (7.3%); and, food with R\$178 billion (7.2)

During that period, very few new companies applied to list on the exchange since only those companies that had simultaneously arranged for US exchange listing were expected to complete a successful listing on BOVESPA. This fact highlights the weakness of Brazil's equity market in those days. Brazilian companies had no alternative but to "rent" the credibility and depth of another better-regarded market if they wanted to gain access to capital by issuing shares in their home market. Meanwhile, a large part of the Brazilian market's liquidity had already been exported to the American exchanges by the late 1990s.

The figures in Chart 4 speak eloquently. They show that, in 2000, the volume traded on the American market by only 28 listed Brazilian companies represented 5.65 percent of the 495 companies registered on the BOVESPA, but accounted for one-third of the exchange's entire trade volume.



*The first ADR program adopted by a Brazilian company was registered in 1996.

Low prices in the secondary market drove many controlling shareholders to remove their companies from the Brazilian market by going private. Prominent among those companies were foreign parents that had acquired control of Brazilian companies during privatization and paid high premiums for that control. Short-term economic logic certainly dictated privatization as the most advantageous course since the regulations then permitted tender offers to delist a company by purchasing shares at prices below the company's economic value.

Chart 5 shows the number of newly registered companies and registration cancellations on the Brazilian exchanges. To better understand these figures, note that the great majority of new registrations of publicly held companies reflected in the chart refer to three types of situations: **state-owned companies** that were registered on the exchange to be privatized; **split-offs** from state-owned companies whose assets, in many cases, had been split up to facilitate their sale; and lastly, **special-purpose companies** interested in buying the privatized state-owned companies. These companies were listed on the exchange simply

to fulfill the privatization auction's terms and conditions. Between 1995 and 2000, there were only eight Initial Public Offerings (IPOs) (i.e., listing of new companies accompanied by share offerings on the market).

The economic situation of Brazil's stock exchanges also reflected this trend. In 2000, more than 90 percent of Brazil's share volume traded on the BOVESPA, while the other eight exchanges handled the remaining volume. In early 2000, "integration" agreements were signed by the nine Brazilian stock exchanges. These agreements concentrated the listing and trading of publicly held companies on the BOVESPA. The other exchanges focused on promoting the financial market in their regions. In practice, since the other exchanges were not purchased by BOVESPA, these agreements ensured that each exchange's members could also become members of the São Paulo exchange and use its trading systems.

Chart 5: BOVESPA – New Company Registrations, Cancellations, 1990–2000



Source: BOVESPA

Available at: <http://www.bovespa.com.br>

This consolidation around São Paulo completed a liquidity transfer process that had intensified in the wake of a major scandal involving the Brazilian options market in the late 1980s. The factors that led to the default of the biggest speculator in that market at that time seriously threatened the financial health of the Rio de Janeiro Stock Exchange, then the leading Brazilian exchange in terms of trading volume.

During that episode, the exchange and several members lost money and credibility with respect to the exchange's inability to maintain an orderly, healthy market in which risks were effectively controlled. This became obvious when, in the mid-1990s, BOVESPA found itself serving as the magnet, attracting practically all the funds that foreign investors were putting into Brazilian capital markets.

Indeed, even during the worst moments of the late 1990s when trade volume plummeted, the São Paulo exchange managed to keep its accounts in balance. As for its future, there was a clear realization of the importance of credibility as a factor in the market's attractiveness.

In the face of an extreme weakening of Brazil's capital market that threatened its very survival, BOVESPA sought to identify alternatives to reverse what seemed then to be an inexorable, downward trend.

Even during the worst moments of the late 1990s when trade volume plummeted, the São Paulo exchange managed to keep its accounts in balance. As for its future, there was a clear realization of the importance of credibility as a factor in the market's attractiveness.

To accomplish this, the factors undermining the attractiveness of Brazil's capital market had to be identified. A group of experienced, highly regarded professionals² was retained to prepare a study. They interviewed key market participants (businessmen, investors, development organizations, regulatory bodies) in developing an analysis that outlined concrete reforms for BOVESPA to implement.

In painting a picture of the problems afflicting the Brazilian market, the comments and criticisms from

representatives of the IFC/World Bank and the OECD attracted special attention. At the time, they were cosponsoring the first Latin American Roundtable on Corporate Governance. Those organizations not only conveyed criticisms from foreign institutional investors concerning Brazil's regulatory environment, but they also supported the reform efforts by sharing relevant international experiences and furnishing a "best practices" benchmark.

Within the context of the country's structural limitations and macro-economic problems, studies pointed out such inadequacies in Brazil's capital market regulations, namely the lack of sufficient guarantees and protections for securities investors.

2 MB Associados (J. R. M. De Barros, J.A. Scheinkman, and L. L. Cantidiano). *Desafios e oportunidades para o mercado de capitais brasileiro [Challenges and Opportunities for the Brazilian Capital Market]*. Published in São Paulo by BOVESPA – Bolsa de Valores de São Paulo, June 2000, p. 52.

Given global investors' concerns about increased macro-economic risks arising from crises in emerging markets at the end of the 1990s, regulatory effectiveness assumed enormous importance. In Brazil, investors seem to have become more aware of risks related to corporate governance, which made them more selective in the securities they wanted to own.

1.2 The Principal Problems

One key problem in Brazil, as pointed out by domestic and international investors, was the predominance of non-voting stock known as “preferred shares” (“ações preferenciais nominativas” in Portuguese, or simply PN). Brazil's Corporation Law authorized publicly held companies to issue up to two-thirds of their capital in the form of such preferred shares. This enabled holders of voting shares to control companies by owning as little as 17 percent of the company's total equity or stock.

In some cases, control structures took the form of pyramids that made it possible for control to be wielded by someone who owned an even smaller portion of the company. This arrangement produced a fundamental misalignment of interests between those who held preferred shares and those who controlled the companies.³ In addition to the fundamental differences between the two groups of shareholders, the structural changes taking place within the companies clearly showed that shareholders didn't have equitable treatment.

For instance, in the process of delisting, the mandatory tender offer to purchase the stock of minority shareholders did not have to assure them of a price that was determined by the company's economic value. More than that, regulations allowed “the squeeze out” of minority shareholders at unfair prices, by permitting the controlling shareholder to purchase outstanding shares, reducing the free float and the liquidity. They could do so even when they were not able to obtain a sufficient quorum to delist the company.

In yet another significant situation—the change in the control of a publicly held company—the Corporation Law again failed to adequately protect minority shareholders. Those shareholders were not entitled to receive a tender offer that

3 This leverage ability was reduced for companies that went public after a legislative reform took effect in September 2002. For new, publicly held companies, the law was changed to permit issuance of only 50 percent of the capital in the form of preferred stock that lacks the right to vote. However, companies that had already gone public before the law was amended maintained the right to use preferred shares to represent up to two-thirds of their total capital, and even to issue new shares of such stock, if necessary. This means that the imbalance between political rights and rights to cash flow had been maintained for the overwhelming majority of Brazil's listed companies.

would have allowed them to sell their shares with the sale of the controlling blocks. This meant that transfers of controlling shares occurred often with extremely high premiums paid to the controlling shareholders. The company's remaining shareholders were left with no alternative other than to perhaps sell their shares at a substantially lower price in the market.

Deficiencies in the regulatory environment and corporate governance practices were taking their toll. Therefore, an exit had to be found that did not depend on major structural reforms that Brazil had not yet completed.

We have only mentioned the most significant problems that affected shareholders, but it is a fact that these and other deficiencies in both the regulatory environment and corporate governance practices were taking their toll.⁴

Therefore, an exit had to be found that did not depend on major structural reforms that Brazil had not yet completed (such as tax, social security, and judiciary reforms) or on amendments to the Corporation Law (which was finally accomplished in 2002, but with results far less significant than those that were needed). BOVESPA sought instruments that it could use as a private agent so that it would be less dependent on developments in Brazil's institutional conditions.

To this end, BOVESPA decided to establish its own listing rules. These rules would help improve the governance of listed companies and, as a result, make the market more attractive to investors. BOVESPA also had to take additional steps to reinforce the exchange's importance in the context of Brazilian society, expand the base of domestic investors in securities, and improve its own competitiveness and efficiency.

4 Although there was room for improvements in 2000 in the Corporation Law and the regulations published by the Brazilian Securities and Exchange Commission (CVM), significant progress has been made in the regulatory environment since then. In 2002, a revision of the Corporation Law was enacted that afforded minority shareholders some important rights. These included: a tag along at 80 percent of the sale price for holders of common stock and the right to elect one member of the board of directors for holders of preferred stock representing 10 percent of the company's capital. That same revision strengthened the CVM by granting it administrative and budgetary autonomy and setting specific terms of office for its directors. The law also strengthened enforcement authority by defining market manipulation and insider trading as crimes. As part of the regulations implementing the law's new provisions, the CVM made very significant refinements in the rules—for example, public offers to purchase shares.

The basic premise guiding the creation of the Novo Mercado was that a reduction in investor perceptions of risk would improve share values and liquidity. Specifically, BOVESPA believed that investors would perceive the risks to be lower if they were granted additional rights and guarantees as shareholders, and if the asymmetry of access to information between controlling shareholders/company management and market participants was narrowed, if not eliminated.

With investors seeing lower risks and stock valuations carrying a lower risk premium, more companies would go public. Those that already were listed would be more likely to announce new issues.

These developments would strengthen the stock market's role as an alternative means of financing for companies and thereby help to harmonize the interests of entrepreneurs and investors. The extremely low number of companies going public on the Brazilian market in the 1990s shows how wide the gap was between business executives and investors in their perceptions of the value of businesses. Their perceptions took into account their exposure to governance risks.

There was then a widely held perception in Brazil that the costs involved in both going public and in maintaining publicly held shares were too high. It was thought that this was the main cause for companies' lack of interest in listing on the stock market. BOVESPA believed that the highest "cost" of all was the share price. In other words, the equity discount that investors demanded because of the risks – other than those associated with the transaction – was a major liability for BOVESPA-listed companies.

BOVESPA believed that investors would perceive the risks to be lower if they were granted additional rights and guarantees as shareholders, and if the asymmetry of access to information between controlling shareholders/company management and market participants was narrowed, if not eliminated.

2. THE NOVO MERCADO AND CORPORATE GOVERNANCE LEVELS 1 AND 2

The Novo Mercado was launched in December 2000 as a special segment of BOVESPA. It was created for trading shares in companies that voluntarily adopted corporate governance practices in addition to those required by Brazilian law. Listing in this special segment subjects a company to a set of corporate rules that expand shareholder rights, require greater transparency, and mandate more comprehensive disclosures.

Novo Mercado companies stand out because they can only issue common stock; they must commit to not issuing any preferred stock in the future.

A change of this magnitude in the composition of companies' capital, although perfectly feasible for companies that were about to go public, would not be as simple for those already listed on BOVESPA. For many of them, two-thirds of their total capital was in preferred stock already outstanding.

At this point, it is useful to comment on some reactions to the proposed rules. Novo Mercado was viewed with some trepidation by some issuers and intermediaries.

Improving corporate governance in Brazil had more to do with equitable treatment of all shareholders than it had to do with the board's composition and practices.

Some large companies with a commanding presence in Brazil's concentrated securities market saw very little upside. Executives and owners of such companies seemed to fear that investors would pressure them to migrate to Novo Mercado, or else punish them for not doing so. Since these blue chip firms already had privileged access to the markets due to their size and history, Novo Mercado merely presented to them the possibility of being cajoled into limiting their flexibility (especially

with respect to issuance of non-voting shares). If they did not join, they risked being criticized for sub-optimal governance.

Others also expressed the fear that Novo Mercado might set inflexible standards, resulting in unfair castigation of companies that could not meet them. This view was expressed in particular by companies with non-voting "preferred" shares and

their investment bankers. Advocates for this view stressed that criteria like one-share one-vote and international financial reporting standards were no guarantee of good governance. Some companies feared that an agreement to private arbitration would result in them facing yet another potential source of abusive, groundless legal proceedings.

Naturally, BOVESPA could not ignore the concerns (some of them legitimate) of its existing issuers. A process of engagement, education, and dialogue was undertaken that figured importantly into the design of the three-tiered approach ultimately adopted (Novo Mercado, Levels 1 and 2). The creation of Level 2 satisfied the concerns of companies whose principal objection to Novo Mercado was that it did not permit companies with an existing stock of preferred shares to demonstrate their commitment to good governance. The quite modest requirements of Level 1 (they focus on transparency and do not include agreement to private arbitration) provided firms with an opportunity to signal at least some commitment to good corporate governance, without fundamentally limiting their flexibility to organize their capital structure or exposing them to another legal forum for settlement of shareholder disputes.

To ensure that all of these companies had a path to follow toward improving their corporate governance practices, Corporate Governance Levels 1 and 2 were created. These two intermediate segments between the traditional BOVESPA market and the Novo Mercado are intended to serve as stepping stones that will facilitate gradual adaptation by companies when direct migration to the top level is not considered feasible.

Level 1 requirements most closely resemble Brazilian regulations but establish additional obligations related to the disclosure of information. Level 2 requires that companies comply with almost all the obligations of the Novo Mercado, except for the possibility of keeping their preferred shares. However, those preferred shares are assured tag-along rights of 80 percent of the price at which control is sold, as well as the right to vote in certain important situations.

The principal listing rules of each segment are described in Box 1. However, a comment is needed here concerning the main objective of the specific rules chosen for the Novo Mercado. In light of the points made during interviews conducted for designing the Novo Mercado, improving corporate governance in Brazil had more

to do with equitable treatment of all shareholders than it had to do with the board's composition and practices.

Given that Brazilian companies generally have a high concentration of voting power in the hands of clearly defined controlling groups, the situation in which shareholders are not involved in company management and the officers have the most clout—found especially in Anglo-Saxon markets—is extremely rare. Hence, it was not the classic agency conflict that characterized the corporate environment in Brazil, but rather the conflict that pits controlling shareholders against minority ones.

This is why the Novo Mercado listing regulations emphasize measures that guarantee equitable treatment of all shareholders and do not, for example, concentrate on provisions about the independence of board directors.

Box 1 – Principal Requirements for Companies Listed in the Special Corporate Governance Segments of the BOVESPA

NOVO MERCADO

Transparency: Improvements in the disclosure of financial data, including quarterly statements with cash flow demonstration and consolidated statements, reviewed by an independent auditor. Present the annual financial statements in an internationally recognized standard (International Financial Reporting Standards or U.S. Generally Accepted Accounting Principles). On a monthly basis, disclose information about the company's securities and its derivatives traded by the insiders and the controlling group. Whenever the contracts between the company and any related party exceed R\$200,000, or one percent of the company's net worth, in a 12-month period, the company must inform BOVESPA.⁵

Corporate governance and shareholders' rights: Issue only voting shares. Give tag-along rights to all shareholders at the full price of the deal. Make a public tender offer at least at the economic value in case of delisting or cancellation of the Novo Mercado's contract with BOVESPA. The board of directors must have a minimum of five members, all with unified mandates of up to two years, and a minimum of 20 percent of independent board members. Discuss through arbitration any shareholder-company dispute that arises related to the listing rules, the company bylaws, Corporate Law provisions, and other norms of the Brazilian capital market. The company also commits to maintain at least a 25-percent free float.

⁵ Information required by the special segments' rules is available on BOVESPA's Website (www.bovespa.com.br).

LEVEL 2

Requires companies to abide by all of the obligations set forth in the Novo Mercado regulations, with a few key exceptions. First, Level 2 companies retain the right to maintain existing preferred shares and issue new ones up to the level permitted by the law. But it is very important to mention that these preferred shares enjoy tag-along rights at the minimum of 80 percent of the price received by the selling controlling shareholder and are also entitled to voting rights in some key situations (such as company mergers and incorporations and contracts between the controlling shareholder and the company), provided they are voted in a general shareholders' meeting.

LEVEL 1

Requires companies to become more transparent by disclosing additional information, such as more comprehensive financial statements (including quarterly statements with cash flow demonstration and consolidated statements, reviewed by an independent auditor). On a monthly basis, disclose information about the company's securities and their derivatives traded by the insiders and the controlling group. Whenever the contracts between the company and any related party exceed R\$200,000, or one percent of company's net worth in a 12-month period, the company must report the details to BOVESPA. Listed companies should also maintain, at least, a 25-percent free float.

By 2002, BOVESPA had amended its mandatory listing rules to require that any new listings involving a public share offering must be registered, at a minimum, as Level 1.

In addition to adopting more advanced corporate governance practices and offering their shareholders guarantees beyond those provided in the legislation, Novo Mercado companies assume an obligation to continue following those practices. The companies' commitment to fulfill additional listing requirements is stipulated in an agreement with BOVESPA that gives the exchange authority to oversee and enforce its regulations and even to impose penalties when necessary.

The most severe action that BOVESPA can take is to remove a company from the segment in which it is listed if the rule violations are sufficiently serious, or are repeated. If BOVESPA does take such action, the controlling shareholder of a

company that is excluded from either Novo Mercado or Level 2 must make an offer to repurchase all the outstanding shares at a price that is at least equivalent to the

In addition to adopting more advanced corporate governance practices and offering their shareholders guarantees beyond those provided in the legislation, Novo Mercado companies assume an obligation to continue following those practices.

shares' economic value. Furthermore, the exchange must disclose any penalties that it imposed.

The Brazilian justice system not only operates very slowly, but it also has very few trial courts that specialize in corporate issues. This is another factor that makes investors uncertain about the enforceability of their rights. This uncertainty clearly would have contributed to lowering the value of those companies listed in the special segments.

This is why the exchange decided to include in the requirements established for the Novo Mercado and Level 2, the mandatory recourse to arbitration for dispute resolutions related to corporate and capital market questions involving the company, its shareholders (including the controlling shareholders), its officers, and BOVESPA. As a complement to the listing rules and BOVESPA's powers to ensure thorough enforcement of the rules, BOVESPA established the Market Arbitration Panel in 2001. This panel is staffed with arbiters who have expertise in the issues that will most likely be heard in this forum. It has operational autonomy and an assured source of funding.

3. IMPLEMENTATION

When the Novo Mercado and Levels 1 and 2 were launched at the end of 2000, analysts forecast a resumption in Brazil's economic growth, which would be triggered by the beginning of a decline in the country's extremely high interest rates. This premise was very important to the new program's success. BOVESPA was counting on Novo Mercado to build a market for IPOs, something that had never existed before in Brazil in sustainable form. During that period, the basic interest rate in Brazil was, in real terms, the world's highest.

But circumstances proved to be quite different in 2001—and not only in terms of the economy. From the exacerbation of the Argentine crisis, to a domestic energy crisis requiring months of electricity rationing, to the attacks on the World Trade Center on September 11, the year was marked by many economic shocks.

In 2002, another factor was added to this scenario: the reaction of Brazilian and international investors to the possibility of a major change in Brazil's economic policy if the presidency were won by forces further to the left of the political spectrum. Brazil's currency, the *real*, suffered a drastic devaluation. The performance of the Emerging Markets Bond Index (EMBI+), a measure of the country's risk premiums, reflected investor concerns.⁶

The Novo Mercado's listing rules, as was already noted, were distant from the true situation in Brazil's publicly held companies, especially because they prohibited preferred shares. That is why BOVESPA expected that this market segment would be comprised largely of new, publicly held companies willing to adhere to its demanding standards in exchange for obtaining better prices for their IPOs.

In light of those unfavorable economic conditions, practically all the companies postponed their plans to go public. Hence, even after its launch, the viability of the Novo Mercado remained a huge question mark for most participants in the Brazilian capital market and the financial press.

Most of those who analyzed the initiative and its chances for success concluded that companies, their shareholders, and the business community itself were all not culturally prepared to accept such advanced corporate governance rules. Many bet against BOVESPA achieving good results, believing that its proposals were too bold. Others supported the proposed listing rules but thought there was very little chance that companies would adopt them. The press reported on those doubts, printing stories about the “failure” of the Novo Mercado.

After its launch, the viability of the Novo Mercado remained a huge question mark for most participants in the Brazilian capital market and the financial press.

⁶ The *real*—the Brazilian currency—lost more than 70 percent of its value in 2002 (71.47 percent on October 22, 2002) while the EMBI+ reached its peak in September, at 2,443 points.

The dramatic change in market conditions meant that the project evolved quite differently than had been anticipated. The original plans maintained that it would be easier to attract already-listed companies after new companies had successfully marketed their shares in the Novo Mercado. But given the total absence of IPOs in the new and the old models, it was the listed companies that ultimately inaugurated the special segments.

At that time, BOVESPA was directing considerable efforts toward attracting listed companies to join one of the three new listing segments. It believed that this migration to segments with differentiated levels of governance requirements was vital to ensure that those companies in whose shares the liquidity of the Brazilian market was concentrated could take part in the evolution that the exchange was proposing.

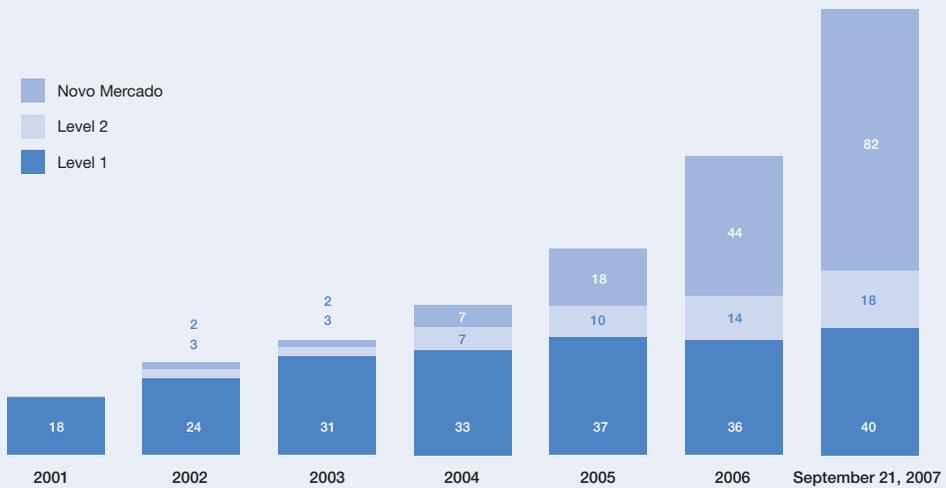
Since adherence by companies to its rules is voluntary, Novo Mercado could only become a reality if investors and other suppliers of capital demanded compliance and if companies considered corporate governance obligations to be advantageous.

But the biggest task for BOVESPA—and the focus of its work at this time—was publicizing the Novo Mercado and its benefits for companies that adopted its better corporate governance practices. This effort was primarily targeted at business leaders, underwriters, domestic and foreign institutional investors, investors in private equity, venture capitalists, and the companies they financed.

As it worked to change the business community's culture and counteract the skepticism, BOVESPA had decisive support from loyal partners who had been on its side since the idea was first conceived.

The first of these partners that should be mentioned is the Brazilian Institute of Corporate Governance (Instituto Brasileiro de Governança Corporativa – IBGC). BOVESPA had worked with IBGC since its founding in 1995. Through its courses and lectures, in addition to the Corporate Governance Best Practices Code, the IBGC gave significant assistance in publicizing and lending prestige to the Novo Mercado.

Chart 6: The Evolution of BOVESPA's Listing Segments



The numbers in the boxes tell how many companies listed on BOVESPA in each listing segment.

Chart 7: BOVESPA – Listing Segments



From the public sector, the program received the seal of approval from the Brazilian Securities and Exchange Commission (Comissão e Valores Mobiliários, CVM) and the agency responsible for overseeing Brazilian pension funds (Secretaria de Previdência Complementar). Those two agencies took the decisive step of supporting the inclusion

Novo Mercado is based on a market mechanism and so—it is important to say this no matter how obvious it may be—its viability depended on the existence of a market.

in the regulations covering pension fund asset investments of authorization for a higher ceiling on stock investments if the issuing company is listed on the Novo Mercado or Level 2. The same regulation established that pension funds could only invest in an IPO if the company were listed on the Novo Mercado or Level 2.

Those pension investment provisions had no practical effect, though, since those investors had then—and still do—an exposure to equities that was well below the established limits. Even so, those rules were extremely important because they helped institutionalize and give official recognition to the existence of the Novo Mercado and both Level 1 and Level 2.

The Brazilian Development Bank (BNDES) also gave vital support for the project from its conception onwards. The BNDES started granting specific incentives for companies to join the Novo Mercado and, in some cases, made such membership one of the conditions for financing.

In these cases, both the regulators and the development bank certainly had in mind reducing investor risks, which they believed would result from companies adopting improved governance practices.

Once again, the World Bank's contributions, through the International Finance Corporation (IFC) and the IFC's Global Corporate Governance Forum, and the OECD were key. In particular, the Forum's Private Sector Advisory Group was essential. This group of major worldwide investors used the international press to publicize its support for the Novo Mercado and the benefits for investors in Brazilian companies. Their enormous prestige and economic clout helped advance the initiative.

Major Brazilian institutional investors⁷ also helped make the project viable by officially supporting it during that very difficult initial phase.

7 The official supporters of the Novo Mercado since its launching were: the BNDES, Bradesco Templeton (asset manager), the IFC, the PSAG, the IFC's Global Corporate Governance Forum, and Petros (a pension fund).

There was yet another private agent of extreme importance, the National Association of Investment Banks (Associação Nacional dos Bancos de Investimento – ANBID). ANBID members include the most active underwriters. As part of its Self-Regulation Code for Public Offers of Securities (Código de Auto-Regulação para Ofertas Públicas de Valores Mobiliários), ANBID stipulated that its members could only lead offers whose issuers are registered, at a minimum, in BOVESPA Level 1.

Novo Mercado could only become a reality if adherence to its voluntary rules was demanded by investors and other suppliers of capital and if companies considered corporate governance obligations to be advantageous.

The Novo Mercado is based on a market mechanism and so—it is important to say this, no matter how obvious it may be—its viability depended on the existence of a market. Since adherence by companies to its rules is voluntary, the Novo Mercado could only become a reality if that adherence was demanded by investors and other suppliers of capital and if companies considered corporate governance obligations to be advantageous. How was BOVESPA to implement that project—or any other one based on market incentives rather than regulatory decisions—under circumstances in which the market was completely “closed” to any issuance of shares in Brazil?

That is why I believe it is important to mention in this article the network of partnerships—and concrete initiatives—involving the public and private sectors that sprung up spontaneously in Brazil around the Novo Mercado. These partnerships can be public and private policy alternatives aimed at helping initiatives that depend on market forces to flourish—even under unfavorable market conditions or in countries where the capital market is not yet sufficiently developed.

As can be seen from the figures presented in the following sections, the Novo Mercado has moved beyond the phase in which its future was uncertain. But it might not have arrived at this stage—it might not have survived the unfavorable conditions long enough to be able to be tested when the market recovered—if it had not been able to count on major, well-coordinated support during its initial phase.

4. INITIAL RESULTS

In June 2001, 15 companies listed on Level 1. By the end of 2001, there were 19 companies on Level 1, representing 19.13 percent of the exchange's market capitalization and 14.39 percent of volume traded. No firms were listed on the Novo Mercado or in Level 2, and there were no IPOs in Brazil that year.

The first company listed on the Novo Mercado in February 2002, the first IPO since the market was created. That transaction for Companhia de Concessões Rodoviárias (CCR) indicated that the Novo Mercado would become the standard that investors would require for new companies seeking to go public. By the end of 2002, BOVESPA had two companies in the Novo Mercado, two in Level 2, and 24 in Level 1. Those segments then represented 23.28 percent of market capitalization and 23.25 percent of volume traded.

In 2003, once again, there were no IPOs in Brazil. But as the economic scenario improved during that year, some publicly held companies did secondary offerings with reasonable success. By the year's end, the special listing segments included 36 companies, representing 34.98 percent of market capitalization and 24.55 percent of volume traded.

5. THE DRAMATIC CHANGE, THE CONSOLIDATION

The year 2004 brought dramatic change to Brazil's capital market. For the first time in more than a decade, several companies who were leaders in their respective fields decided to go public. There were seven new listings, five of them on the Novo Mercado and two in Level 2. The two companies that joined Level 2 were public service concessionaires that were not eligible for the Novo Mercado because of specific restrictions, whether imposed by regulations or by their concession contracts (e.g., pertaining to the ownership of their voting stock).

Among companies already listed on the BOVESPA, eight conducted public distributions of shares in 2004. Two of these had already registered on the Novo Mercado (follow-on deals), another company joined Level 2, and the remaining listed on Level 1.

BOVESPA was able to end the year with seven companies listed on the Novo Mercado, seven on Level 2, and 33 on Level 1, representing 39.48 percent of market capitalization and 33.81 percent of exchange-traded volume.

The year 2005 was a magnificent year that convinced BOVESPA, market agents, and opinion-makers in general of the viability of the model proposed for Novo Mercado and the other segments. Nine companies conducted IPOs; seven of these registered on the Novo Mercado while the other two joined Level 2.

That same year, ten of the already-listed companies did secondary offerings. Three of them deserve specific comment because they revealed yet another way found by companies (and their controlling shareholders) to reap benefits resulting from listing on the Novo Mercado.

In those three cases, the share distributions virtually constituted the companies' IPOs. All of them had been uninvolved with the market, having an extremely low free-float and little interest in dedicating the necessary resources for investor relations. They converted all their preferred stock into common stock (with voting rights) and joined the Novo Mercado. Their new share offerings obtained prices much higher than their shares' quotes during the preceding period.

The year 2005 ended with a total of 19 companies listed on the Novo Mercado, 10 in Level 2, and 36 in Level 1, representing 48.15 percent of the market capitalization and 45.95 percent of volume traded on BOVESPA.

For the first half of 2006, 11 new companies launched IPOs. Nine of them registered with the Novo Mercado and two on Level 2. But there were also nine public stock offerings by companies that were already listed; four on the Novo Mercado, two on Level 2, and three on Level 1.

The first company listed on the Novo Mercado in February 2002. That transaction for Companhia de Concessões Rodoviárias (CCR) made it clear that the Novo Mercado would be the standard that investors would require for new companies seeking to go public.

These results are extraordinary from many different standpoints, especially when compared with the history of Brazil's capital markets. There have been other periods when the primary market was very active, when a number of companies

These results are extraordinary from many different standpoints, especially when compared with the history of Brazil's capital markets. There have been other periods when the primary market was very active, when a number of companies went public, but never anything like we are seeing now, obeying an exclusively market-related logic, accompanied by appropriate incentives.

went public, but never anything like we are seeing now, obeying an exclusively market-related logic, accompanied by appropriate incentives. During the 1970s, when the highest number of new listings ever seen on a Brazilian exchange occurred, tax incentives were available for publicly held companies and for those who invested in those companies' stock. Both incentives were eliminated years ago.

By year-end 2007, 156 companies were listed on Novo Mercado and Levels One and Two, represented 57 percent of BOVESPA's total market capitalization, 66 percent of the trading value, and 74 percent of the number of trades in the cash market.

Without seeming overly optimistic, the Novo Mercado and the other special segments have entered a period of consolidation, having exceeded every prediction made of those who originated the idea in terms of the speed and intensity of the market's evolution.

6. HIGHLIGHTS

In addition to the importance of the current cycle in the Brazilian capital market from a quantitative standpoint (e.g., the remarkable activity in the primary market), there are other aspects that deserve comment because they represent important leaps forward in this sector's evolution.

6.1 The Role of Foreign Investors

Among the most remarkable aspects of the process related to the installation of the Novo Mercado is the enthusiastic acceptance by foreign investors of the stock offerings. On average, the public subscribed to more than 70 percent of the shares offered, although very few companies sought registration on any foreign market.

Among the 27 IPOs since 2004, only two companies were listed simultaneously on the New York Stock Exchange (NYSE). In all the other cases, the shares were offered to foreign institutional investors without having been registered with the U.S. Securities and Exchange Commission (SEC) or any other foreign authority. Those investors brought funds to Brazil to pay for their purchases and have relied solely on the country's capital market liquidity.

No doubt, the high degree of foreign investors' receptivity demonstrates their favorable opinion of the Novo Mercado rules and companies' adherence to the new governance practices.

Besides making it feasible to market transactions involving very significant amounts of money, something that would not be viable in a strictly domestic environment, this participation by foreigners was vital in pricing the securities. More than half the companies that went public came from industries that had not previously been represented on a Brazilian stock exchange. Therefore, there were no comparables on the local market that could serve as a reference to establish prices, although similar companies and sectors could be found on other international exchanges.

Furthermore, the possibility of gaining access to foreign capital without having to arrange for listing on another market has significantly reduced companies' costs (specifically, those costs associated with both the IPO procedure and the expense of maintaining a dual listing).

Foreign investor local participation helped expand the range of companies that will be able to conduct a successful IPO by permitting a reduction in the transaction's minimum size. Under a scenario like the one that prevailed during the 1990s (which necessarily involved a simultaneous listing on a foreign stock exchange) the absolute value of each deal would have to be large enough to guarantee a minimum of liquidity on each of the markets where the security was to be traded. Now that liquidity can be concentrated solely on the domestic market, certainly the figure that was considered to be the minimum size for such operations has been reduced.

Chart 8: Participation by the Listed Companies in the Special Segments, 2001–2006



Source: BOVESPA

Available at: <http://www.bovespa.com.br> *Through June 2006

Table 1: Stock Distributions, 2004–2006

	Company Name	Nature	Segment	Offering Volume (US\$)	Foreign Participation %
	CCR	Primary	Novo Mercado	120,003,842	75
	Natura*	Secondary	Novo Mercado	243,230,094	67
	Gol*	Mixed	Level 2	282,996,616	75
	ALL*	Mixed	Level 2	189,164,201	71
	Weg	Secondary	Level 1	109,596,047	41
	Braskem	Mixed	Level 1	421,419,871	74
2004	CPFL Energia*	Mixed	Novo Mercado	287,029,639	69
	Grendene*	Secondary	Novo Mercado	215,963,592	64
	Sabesp	Secondary	Novo Mercado	251,071,814	81
	DASA*	Mixed	Novo Mercado	158,260,310	68
	Porto Seguro*	Mixed	Novo Mercado	136,330,120	71
	Gerdau	Secondary	Level 1	148,790,791	79
	Gerdau Metalurgica	Secondary	Level 1	31,814,479	28
	Bradespar	Primary	Level 1	379,724,543	66
	Suzano Pet.	Mixed	Level 2	65,563,181	35
Total				3,040,959,140	69
	Unibanco	Secondary	Level 1	273,656,700	57
	Renar Maçãs*	Primary	Novo Mercado	6,165,703	5
	ALL	Secondary	Level 2	253,326,671	80
	Submarino*	Mixed	Novo Mercado	176,416,555	75
	Ultrapar	Mixed	Traditional	141,419,205	75
	Gol	Mixed	Level 2	235,437,840	79
	Localiza*	Secondary	Novo Mercado	108,113,640	93
	TAM*	Mixed	Level 2	225,948,012	74
	AES Tietê	Secondary	Traditional	433,383,800	80
2005	Lojas Renner	Mixed	Novo Mercado	377,692,464	86
	EDP*	Mixed	Novo Mercado	504,515,256	26
	OHL*	Mixed	Novo Mercado	211,721,514	70
	Unibanco	Secondary	Level 1	757,595,466	80
	Bradespar	Secondary	Level 1	219,476,473	67
	Cyrela	Mixed	Novo Mercado	396,525,580	72
	Nossa Caixa*	Secondary	Novo Mercado	418,546,775	71
	Cosan*	Primary	Novo Mercado	399,228,074	72
	Tractebel	Secondary	Novo Mercado	468,546,734	55
	UOL*	Mixed	Level 2	267,460,432	71

Table 1: Stock Distributions, 2004–2006 (continued)

	Company Name	Nature	Segment	Offering Volume (US\$)	Foreign Participation %
	lochpe	Secondary	Level 1	153,127,689	47
	Copasa*	Primary	Novo Mercado	370,496,231	74
	Vivax*	Mixed	Level 2	241,027,510	69
	Rossi	Mixed	Novo Mercado	472,358,293	80
	Gafisa*	Mixed	Novo Mercado	437,358,293	72
	Company*	Mixed	Novo Mercado	133,245,008	64
Total				7,682,789,918	69
2006	Totvs*	Mixed	Novo Mercado	212,962,963	69
	TAM	Mixed	Level 2	728,562,165	80
	DASA	Mixed	Novo Mercado	306,658,923	85
	Equatorial*	Mixed	Level 2	215,288,372	77
	Saraiva	Mixed	Level 2	85,326,743	86
	Duratex	Mixed	Level 1	284,579,439	46
	Submarino	Mixed	Novo Mercado	435,450,375	91
	Localiza	Mixed	Novo Mercado	185,552,493	74
	Abnote*	Secondary	Novo Mercado	227,694,213	80
	Randon	Mixed	Level 1	112,535,984	57
	CSU*	Mixed	Novo Mercado	164,721,052	83
	BrasilAgro*	Primary	Novo Mercado	281,739,130	82
	Lupatech*	Mixed	Novo Mercado	207,678,910	78
	Datasul*	Mixed	Novo Mercado	140,271,021	80
	Banco do Brasil	Secondary	Novo Mercado	1,021,207,974	51
Total**				4,610,229,757	72
Total 3 Years				15,333,978,815	70

Source: BOVESPA

Available at: <http://www.bovespa.com.br> *IPOs **Through June 2006

Note: The percentages for foreign participation are approximate. Data is available on BOVESPA's Website.

6.2 Receptivity to Secondary Offerings

Another characteristic of the recent offerings that merits special mention is the ready acceptance by investors of secondary offerings. There have even been successful offerings in which only existing shares were sold without one cent going to the company.

Although it is logical that markets have a preference for the sale of newly-issued shares (whose price is based on the issuing company's value), the peremptory rejection of secondary offerings may adversely affect legitimate strategies and ultimately deprive investors of an opportunity. Until the advent of the Novo Mercado, investors in Brazilian companies were rejecting such deals.

It appears that the improvement in companies' governance rules has made investors more confident to such an extent that 23 secondary offerings were observed among the 27 IPOs held during this cycle.

More than half the companies that went public came from industries that had not previously been represented on a Brazilian stock exchange.

That rehabilitation of secondary offerings facilitated the exit (usually partial) of investors in private equity and venture capital, thereby permitting a recycling of their portfolios and breathing new life into the entire venture capital industry in Brazil. Also observed were transactions by which families divested part of their holdings, thereby diversifying and freeing funds for other investments. There are even cases where family conflicts were resolved by the departure of certain partners.

6.3 Participation by Individuals

The few IPOs that took place in Brazil during the 1990s had been oriented only toward institutional investors, primarily foreign ones. Owing to the lack of depth in the local market, only large transactions that could simultaneously list on a foreign exchange were conducted. This ultimately meant that only those intermediaries with the ability to distribute shares to institutions, especially those overseas, could lead the offerings.

In transactions conducted at the end of 2003 and thereafter, it was observed that issuers and underwriters were also concerned with attracting individual investors, with a view toward achieving greater diversification of shareholders and greater liquidity after listing. The regulations of the Novo Mercado and the other segments include a stipulation that in any public offering, the company should make efforts to achieve diffuse shareholder ownership and avoid over-concentration of ownership.

The result is that large pools of financial institutions have been assembled, some having more than 50 brokers, to assist the leaders of a syndicate in distributing stocks to retail investors. Those consortia have been joined by many small and medium-sized brokers operating in Brazil, which have been responsible for placing roughly eight percent of the offerings.

Although this may appear to be a rather insignificant portion of total operations, it has been very important in another way. In addition to offering individuals the opportunity to participate in an IPO, thereby helping expand the culture of equity investing in Brazil, those retail tranches led to an important revitalization of an entire segment of the brokerage industry, the small and medium-sized firms.

The improvement in companies' governance rules has made investors more confident to such an extent that 23 secondary offerings were observed among the 27 IPOs held during this cycle.

This kind of intermediary—better qualified because of these recent experiences—may someday lead the offerings of small and medium-sized companies, which should resume in Brazil as part of the virtuous cycle of the capital market.

We have already observed that smaller and smaller companies are going public, thus reinforcing this expectation. BOVESPA's strategy for attracting small and medium-sized companies involves the launching of BOVESPA MAIS (BOVESPA PLUS), a separate segment

within the organized over-the-counter market administered by the exchange. That special segment also sets strict rules on governance and shareholder protection, offering greater support to those listed companies.

7. THE IMPACT OF GOVERNANCE RULES ON PRICES

After the first registrations in the special segments, starting with Level 1 in June 2001, BOVESPA began to calculate an index known as the IGC – Index of Shares with Differentiated Corporate Governance [*Índice de Ações com Governança Corporativa Diferenciada*]. As soon as a company has been registered in one of the three segments, its shares are included in the IGC portfolio. This portfolio's methodology uses differentiated weights for shares of Novo Mercado companies than for companies on the other levels.⁸

Chart 9 shows how the IGC price index has performed more favorably when compared with the Ibovespa, a broader index of the most liquid stocks. The IGC rose 327 percent between June 26, 2001 and June 30, 2006, while the Ibovespa gained 168 percent during this same period.

Although this article does not pretend to offer scientific evidence concerning the influence of governance practices on stock prices, a few figures are presented related to the multiples obtained by Novo Mercado and Level 2 companies in their IPOs. International experience has demonstrated that, when they first offer their shares, companies find that their appraisals are discounted by investors; however, in Brazil, most of the companies that have recently gone public have instead obtained prices higher than the market averages.

After the shares began trading on the exchange, we observe performance that is generally better than the market for shares of the IPOs that took place in that period. Chart 10 compares the evolution of the Ibovespa and IBrX⁹ indices with a hypothetical index of IPO performance that uses the volume of offerings as weighting criterion. The absolute return on that index between May 30, 2004

Large pools of financial institutions are being assembled, some having more than 50 brokers, to assist the leaders of a syndicate in distributing stocks to retail investors.

8 The IGC portfolio is composed of all the companies that have been admitted for trading in the Novo Mercado and at BOVESPA Levels 1 and 2. The shares in the index portfolio are weighted by multiplying their respective market values (considering shares available for trading) by a governance factor. That factor is equal to 2 for the Novo Mercado shares; 1.5 for Level 2 securities; and 1 for Level 1 paper. A single company's participation in the IGC may not exceed 20 percent at the time of its conclusion, or in periodic re-evaluations. If that happens, adjustments will be made.

9 The IBrX – Brazil Index [*Índice Brasil*] is a price index that measures the return on a theoretical portfolio composed of 100 shares selected from those most traded on the BOVESPA, in terms of number of transactions and financial volume. Those shares are weighted in the index portfolio by their respective numbers of shares available for trading on the market (free float). In contrast, the Ibovespa – BOVESPA Index, the most traditional index of the Brazilian securities market, has in its theoretical portfolio shares that have satisfied certain liquidity criteria. The Ibovespa is weighted by the number of trades and by the financial volume traded.

(shortly after the listing of the first company in the cycle of offers commented on here) and July 5, 2006 was 209 percent in nominal *reals*, compared with 116 percent for the IBrX and 86 percent for the Ibovespa.

8. CHALLENGES

In view of all that has been achieved by BOVESPA and the Brazilian capital market during this process, the most obvious challenge is to make certain that the new environment remains responsive to changes in the market reality and to the emerging needs of both investors and companies.

This is why, early in 2006, BOVESPA implemented the first revision of the regulations for listing on the Novo Mercado and Levels 1 and 2 since their creation. The purpose was to update the rules and maintain the exchange's appeal. It was not a comprehensive reformulation of the rules; it involved certain changes in content and some refinements stemming from BOVESPA's experience in applying the listing rules during the preceding five years. Also, during that period, some of the requirements had been incorporated into law or the CVM regulations, which meant they could now be deleted from the BOVESPA regulations.

The principal changes in content pertain to the board of directors. Provisions were included that, first, required at least 20 percent of the directors to be independent and, second, permitted directors' terms of office to be up to two years.

Chart 9: Comparison of Yields between the Ibovespa and the IGC



Source: BOVESPA

Available at: <http://www.bovespa.com.br> *Through June 2006

But the most significant fact that is appearing in the Brazilian market, largely as a result of the very creation of the Novo Mercado, is the emergence of companies that have no defined controlling shareholder. Under the listing regulations, these are called “companies with diffuse control.”

As has already been noted, the voting stock in the vast majority of Brazilian companies is concentrated in the hands of families, family groups, the Brazilian government, foreign groups, and even groups of financial investors who are bound by shareholders’ agreements. Until very recently, there were practically no companies listed that did not have a shareholder (or group) controlling the absolute majority of its voting stock.

After the recovery of the IPO market in Brazil, and with the favorable pricing that has been obtained through those offers, even the idea of selling blocs of control in a public offering to the market became a concrete possibility. We have already seen successful examples of this, enabling not only the financial investors in a company, but also the controlling shareholders, to divest.

Chart 10: Comparison of Yields between the Ibovespa, IBrX, and the IPO Index



Base: May 2004 = 100

Source: Dynamo Administração de Recursos Ltda.

Table 2: IPO Multiples

		Segment	P/E	P/EBITDA
	Average of BOVESPA's 30 most liquid companies in December 2003		17.6	4.5
	Natura	Novo Mercado	30.1	9.3
	Gol	Level 2	25.7	15.2
	ALL	Level 2	38.5	7.1
2004	CPFL	Novo Mercado	50.4	4.7
	Grendene	Novo Mercado	20.3	11.4
	DASA (1)	Novo Mercado	–	23.1
	Porto Seguro (2)	Novo Mercado	11.2	–
	Average of BOVESPA's 30 most liquid companies in December 2004		12.1	3.8
	Renar	Novo Mercado	62.4	10.0
	Submarino	Novo Mercado	155.4	36.6
	Localiza	Novo Mercado	6.4	2.3
	TAM	Level 2	6.9	6.0
2005	Energias Br	Novo Mercado	11.2	3.7
	OHL	Novo Mercado	25.4	5.9
	Nossa Caixa (3)	Novo Mercado	4.9	–
	Cosan (4)	Novo Mercado	–	11.4
	UOL	Level 2	8.2	23.3
	Average of BOVESPA's 30 most liquid companies in December 2005		13.1	5.1
	Copasa	Novo Mercado	9.1	4.6
	Vivax	Level 2	69.8	29.9
	Gafisa	Novo Mercado	74.2	32.5
	Company	Novo Mercado	55.2	8.8
	Totvs	Novo Mercado	59.6	29.5
	Equatorial	Level 2	13.4	16.5
2006	Abnote	Novo Mercado	14.3	8.9
	CSU	Novo Mercado	52.8	13.5
	BrasilAgro (5)	Novo Mercado	–	–
	Lupatech	Novo Mercado	16.5	9.9
	Datasul	Novo Mercado	24.5	14.5
	Average of BOVESPA's 30 most liquid companies in December 2006		17.4	–

***Through June**

In selecting the 30 most liquid companies, the volume traded during the respective year was used.

(1) Dasa showed a net loss of US\$6.38 million in the four quarters prior to the offer.

(2) Porto Seguro is an insurance company.

(3) Nossa Caixa is a financial institution.

(4) Cosan showed a net profit of US\$0.921 million during the four quarters prior to the offer.

(5) BrasilAgro was pre-operational at the time of the offer.

Source: *Econômica*

There have also been cases in which former controlling shareholders, sometimes even the same entrepreneur who built the business, have, after the IPO, sold off portions of their holdings and become minority shareholders. Some of those shareholders themselves have said that the governance rules put in place by the Novo Mercado made them sufficiently comfortable about remaining minority shareholders in the companies they founded.

This new reality means new challenges for the exchange, regulators, and investors. Because of the way that the exercise of controlling power in the companies is defined in law, and because of the main conflict that the Novo Mercado sought to minimize when it was created, its listing regulations impose several obligations on the controlling shareholders. But if no shareholder has more than half the voting stock, how do we guarantee investors the rights they believe they have when they purchase stock in a company listed on the Novo Mercado?

BOVESPA has attempted to deal with situations in which control over the company is exercised in a diffuse fashion (by less than 50 percent of the voting stock) or those cases in which there really is no shareholder (or group) that can be considered to hold control. The answer has been to require changes in the clauses of a company's bylaws based on the regulations.

It can be said that this problem is typical of a regulatory transition—from an environment in which the controlling shareholder was always defined and known to another where that control may not even exist. But there is yet another set of challenges that can be considered new in the Brazilian context, although these have long been the reality in the more developed markets. These challenges are associated with the famous agency conflict—the tension between shareholders and the managers (the agents) they hire to run the company on their behalf. Not only BOVESPA, but all the principal agents of the Brazilian market are aware of the need to see that governance structures and practices exist that would help prevent and deal with the problems resulting from that conflict. In this regard, consultation with entities having international experience will, once again, be essential.

The most obvious challenge is to make certain that the new environment remains receptive to changes in the new market reality and to the new needs of both investors and companies.

Finally, a comment on something that goes beyond the regulations and requirements established for exchange rules—the importance of effectively raising the awareness of companies, their shareholders, and the executives who work for those companies, of the enormous benefit that can result from the adoption of corporate governance best practices. This belief will result in medium- and long-

It is important to raise the awareness of companies, their shareholders, and the executives who work for those companies, of the enormous benefit that can result from the adoption of corporate governance best practices. This belief will result in medium- and long-term policies and in daily practices, that can raise a company's performance and shareholders' returns.

term policies, and in daily practices, that can raise company performance and the returns delivered to shareholders.

More than producing and disclosing tons of information, company executives must inform shareholders with a concern for the clarity and truth of what is being disseminated. It is much more important than merely following lists of rules to ensure that the governance structures and processes actually work for the company's good. The Novo Mercado and the other segments feature some basic measures oriented toward aligning a company's interests among shareholders. It is possible and desirable that these tools be used as the beginning of a continuous process of evolution, based on the principles of good governance: transparency, fairness, and accountability.

CORPORATE GOVERNANCE REFORM ACTIVITIES IN BRAZIL AND IFC SUPPORT

Timeline of Events through 2006

April 2000

IFC co-organizes first meeting of OECD/World Bank Group Latin America Corporate Governance Roundtable in São Paulo.

July 2000

Delivery of IFC/World Bank study “Corporate Governance Issues in Capital Market Development” to Minister of Finance, President of Central Bank, and President of the securities regulator (CVM).

September 2000

IFC organizes meeting between PSAG’s Investor Task Force (including TIAA-CREF, Capital International, CalPERS, New York State Pension Fund, New York City Pension Fund) and CEOs from eight of Brazil’s largest companies.

November 2000

PSAG and IFC provide written commentary on proposed legal/regulatory reforms and draft Novo Mercado rules.

May 2001

IFC organizes New York “Road Show” for Novo Mercado where PSAG Investor Task Force (including TIAA-CREF, Fidelity, New York City Pension Fund, General Motors Pension Fund, Morgan Stanley, Deutsche Bank and Foreign & Colonial). Meets CEO of BOVESPA

at TIAA-CREF in New York. Event is covered in *The Wall Street Journal*.

June 2001

PSAG and IFC Co-Sponsor Launch of Level 1 in São Paulo.

September 2001

IFC Conducts CG and HR Management Seminar for Corporate Executives in Rio de Janeiro (with participation of US NACD).

October 2001

IFC sends letters to all its listed company investees enquiring about their intentions with respect to Novo Mercado and encouraging them to adhere to its rules.

November 2001

PSAG and IFC speak at the IBGC annual congress and at BOVESPA to promote the Novo Mercado.

IFC conducts appraisals of potential investee companies and develops programs of corporate governance improvement with such companies.

February 2002

CCR, a highway concessionaire, completes the first IPO to be listed on the Novo Mercado in R\$305 million offering.

February 2002

IFC board approves IFC's sponsorship of, and investment in, the Brazil Corporate Governance Fund.

April 2002

IFC co-organizes third meeting of OECD / World Bank Group Latin America Corporate Governance Roundtable, and organizes (with support from the Global Corporate Governance Forum) the first meeting of Institutes of Directors of Latin America (including Brazil's IBGC).

June 2002

SABESP, a large sanitation company, becomes the second company to complete an IPO on the Novo Mercado, offering R\$527 million in shares.

November 2002

Second meeting of Institutes of Directors of Latin America is hosted by Brazil's IBGC. Twenty-seven experts from seven Latin American institutes share experiences and training approaches. The Global Corporate Governance Forum sponsors the meeting, IFC organizes it, and IRTF participates.

Speakers from IRTF, Yale, and the IFC address Third Annual Congress of IBGC. The Forum sponsors the IRTF and Yale speakers. Members of the institutes from the rest of Latin America also participate.

March 2003

IBGC and IFC representatives meet with US Securities and Exchange Commission to lobby against an

exemption for Brazilian companies from the audit committee requirements of the regulations under the Sarbanes-Oxley Act.

August 2003

IBGC delegation participates in the Global Corporate Governance Forum Leadership Program in Washington, DC.

July 2004

IFC and OECD organize and moderate panel on regional corporate governance developments at International Corporate Governance Network (ICGN) meeting in Rio.

September 2004

IFC invests US\$20 million in Puma II Fund managed by Dynamo. The fund invests in undervalued companies whose management and controllers are committed to improvements in corporate governance.

CPFL (IFC investee company) lists on Novo Mercado.

October 2004

IFC provides ABN AMRO a US\$50 million credit line to finance sustainability-oriented lending, including credits to family-owned, middle-market companies improving their corporate governance standards.

IFC co-organized fifth Latin American Corporate Governance Roundtable in Rio, with sponsorship from the Forum. Event focuses on issues of enforcement and institutional investor activism.

November 2004

IFC Director for Latin America and the Caribbean addresses fifth annual congress of IBGC.

May 2005

Meeting of the Latin American Corporate Governance Roundtable Task Force in São Paulo. The Forum provides sponsorship.

May 2005

Inaugural meeting in São Paulo of the Companies Circle of the Latin American Corporate Governance Roundtable, with the Forum's support. Seven initial members agree on a plan of action including creation of a guidebook on how to begin the corporate governance improvement process and regular dialogue with investor community.

May 2005

IFC organizes presentation on Bovespa's new "Access Market" for IFC clients and others potentially interested on listing on this new market segment for first-time issuers.

November 2005

Tenth Anniversary meeting of the Brazilian Institute of Corporate Governance. The Latin American Companies Circle's "Case Studies of Good Corporate Governance Practices" is distributed.

Spring 2006

Brazilian companies Marcopolo and Embraer join the Companies Circle.

June 2006

CCR, Natura, Suzano (Companies Circle members) and the IFC present at the APIMEC/BOVESPA seminar on Corporate Governance and Access to Capital.

November 2006

Third meeting of the Companies Circle held in Sao Paulo, coinciding with the annual meeting of the Brazilian Institute of Corporate Governance. Second edition of "Case Studies of Good Corporate Governance Practices" released.

NOVO MERCADO VERSUS ROMANIA'S TRANSPARENCY PLUS TIER—A MIRROR IMAGE?

By Petra Alexandru

ABSTRACT

The Bucharest Stock Exchange implemented a new segment within its market, the “Transparency Plus Tier,” which required companies to adhere to corporate governance requirements. The Novo Mercado’s standards were requested by the investors and left to the companies’ discretion to apply a more or less voluntary approach. The Romanian Corporate Governance Codes and Principles and the T+ Tier were imposed upon listed companies as mandatory requirements. The result in Romania has been a near failure, given that only one company had applied to be listed on the T+ Tier through 2006. Why? Romania’s capital market was not prepared to implement corporate governance standards. The positive attitude of the local issuers towards such standards was overestimated. While most companies declared their support towards observing corporate governance rules, very few were willing to introduce them in their charters. To succeed, the approach needs to be modified to take into consideration local economic conditions, history, and behavior. Despite the failure of the T+ Tier, the exchange did achieve several notable successes. Some blue chip companies have adopted portions of the code’s provisions. In addition, BVB is implementing the “comply or explain” approach in 2008 to adhere to European Union regulations on corporate governance.

1. INTRODUCTION

The Novo Mercado case study by Maria Helena Santana, chairperson of the Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários), as well as our participation in the Global Corporate Governance Forum sponsored Fifth International BELEX Conference in Belgrade, Serbia in November 2006—both events prompted me to reflect on the similarities and differences between the two markets. Given that these markets are situated in totally different “worlds,” the challenge of such a comparison between the two became more and more appealing. In the following pages, I explore the T+ Tier and compare it with the Novo Mercado.

Editor’s note: Original draft December 2006

2. THE ENVIRONMENT

Adoption of the Securities and Exchanges Act (Law no. 52/1994) in 1994 by Romania's parliament made possible the re-construction of the country's capital market.

Romania's capital market dates back to the end of the 19th century, when a Royal Decree created the first commodities and stock exchanges. The Bucharest Stock Exchange opened in December 1882 and, until World War I and mostly before World War II, played an important role in the region. Between WWII and the end of 1989, we saw the disappearance of capitalism. The state was the economy's only owner. All forms of securities vanished and so did the stock market.

The Bucharest Stock Exchange (BVB) was re-created in April 1995 by a decree of the Romanian National Securities Commission (RNSC; Comisia Națională Valoilor Mobiliare) at the request of 24 brokerages—the founding members—seeking to trade on the exchange. BVB started operations in November 1995 with only nine listings that the 29 brokerages traded using a fully automatic and integrated trading system of Canadian origin.

First conclusion: At the end of 1990s, while the Brazilian market was facing a huge crisis, the Romanian market was facing a new beginning.

3. THE MAIN PROBLEMS

The year 1996 marked the beginning of the Mass Privatization Program (terminated March 31, 1997), which had three major effects on the stock market:

- About 4,000 companies became publicly owned and tradable on the stock market within less than two years.
- Romania immediately gained more than 15-million new shareholders (more than 60 percent of the country's population).
- The RASDAQ market was established as the nation's post-privatization organized market.

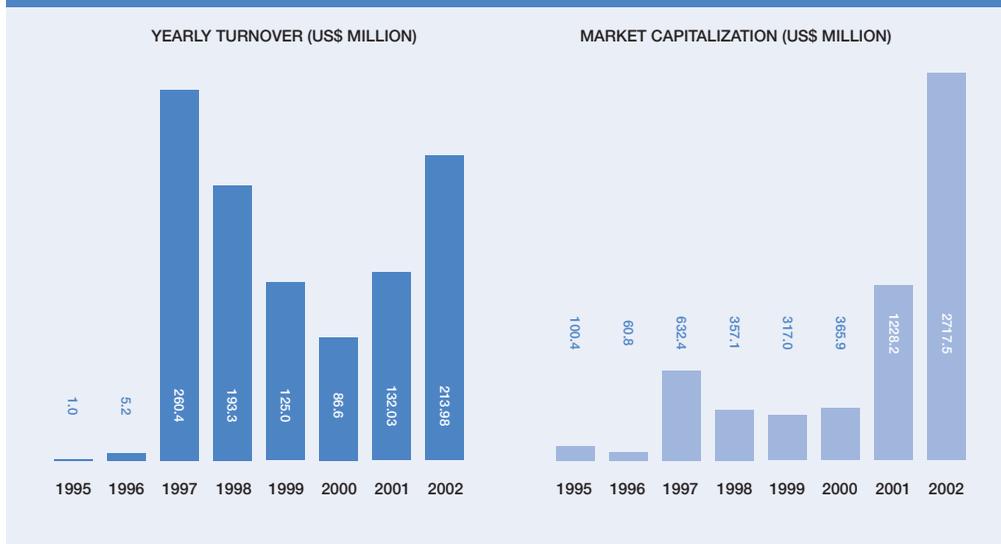
As an immediate consequence, the Romanian capital markets and the listed BVB companies moved ahead quickly in 1997 as foreign investors anticipated the potential for economic reform. However, progress was reversed by crises in the Far East and Russia, which caused the BVB indices to fall sharply.

Between 1998 and 1999, although the major western equity markets rapidly recovered and continued one of the greatest bull markets ever, the young BVB market performed poorly, mainly due to the Romanian economy's poor performance. Internal and external factors—including the Danube River blockade during the North Atlantic Treaty Organization (NATO) intervention in Kosovo and the severe drought in 2000—played a role in the country's economic performance.

BVB officials, concerned about the capital market's evolution, took steps to improve the market and its participants, mainly issuers. The core decision was to raise the listing standards, switching from a quantitative to a qualitative approach.

Concerned about the capital market's evolution, BVB officials took steps to improve the market and its participants, mainly issuers. The core decision was to raise the

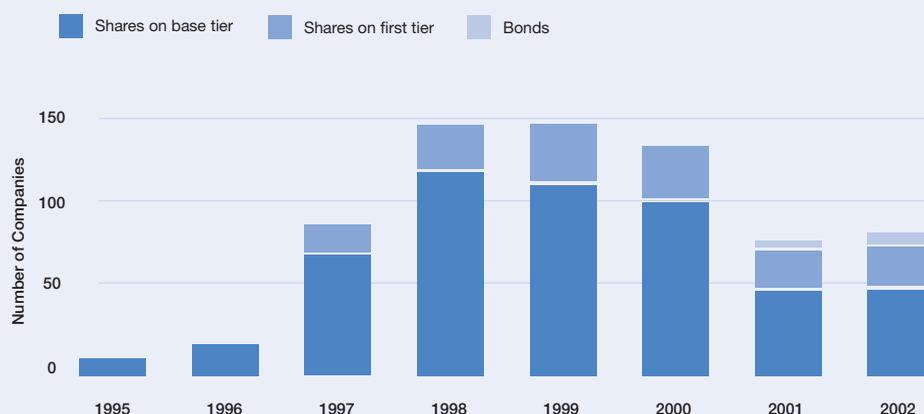
Chart 1: Bucharest Stock Exchange—Turnover, Market Capitalization, 1997–2002



Source: Bucharest Stock Exchange

Available at: <http://www.bvb.ro>

Chart 2: Evolution of Listed Companies at BVB



Source: Bucharest Stock Exchange

Available at: <http://www.bvb.ro>

listing standards, switching from a quantitative to a qualitative approach. For BVB to be viable, the number of listed issuers was no longer sufficient in and of itself. The exchange had to raise its listing requirements and offer its listed issuers adequate incentives to become more transparent and, hence, attract more investors.

At the end of 1990s and early 2000s, BVB had 65 listed companies; 19 were listed on the first tier and four of these companies were only floating municipal bonds.

Second conclusion: While the Brazilian market was confronted with an overwhelming number of preferred shares that locked in concentrated control of companies, the Romanian market was “flooded” with both recently privatized companies, many of which were not fit for the market, and thousands of “idle” common shareholders (post-privatization voucher shareholders).

4. THE TRANSPARENCY PLUS TIER AND THE BVB CORPORATE GOVERNANCE CODE

BVB—Leading Promoter of Corporate Governance Principles in Romania

BVB listings were structured into three sections:

- Securities issued by the Romanian legal entities: **Domestic Equities Sector**, which was divided into two tiers (Base Tier and First Tier)
- Bonds and other debt securities issued by the government and central and local administration public authorities: **Domestic T- and Muni- Bonds Sector**
- Securities issued by foreign legal entities: **International Sector**

The listing process was governed by BVB rules and procedures, which established requirements for admission, maintenance, and upgrading of securities. They stipulated listing requirements and defined issuers' obligations to disclose the information on a timely, continuous basis.

The Base Tier listing requirements provided for:

- public offerings through a prospectus
- registered securities with the National Securities Commission Office
- freely transferable, dematerialized securities
- minimum share capital of two-million euros (equivalent in ROL)*
- company disclosure requirements
- annual reports audited by external, independent auditors
- written listing and maintenance requirements

First Tier listing requirements were:

- Base tier requirements, except for the share capital, which must equal at least eight-million euros (equivalent in ROL)*, plus:
- three years minimum of operating history proved by financial reports

* adopted in 2000 and implemented in 2001

- net profit, excluding financial revenues, for the last two years
- 15 percent free-float (shares to be held by at least 1800 shareholders; each of the 1800 shareholders to own shares amounting to at least 100,000 ROL; the 15-percent free-float to equal at least 75,000 shares).

The listing rules lay down strict guidelines regarding the disclosure of price-sensitive information, which has to be announced to the exchange prior to any other dissemination.

In 2000, BVB adopted modifications to its listing rules, including the creation of the T+ Tier and a Corporate Governance Code. The new rules included a requirement

To be promoted to the T+ Tier, companies were not necessarily required to perform better, but they were required to provide better disclosure and be more transparent.

that already listed issuers had to increase their share capital to the amounts mentioned above. The BVB board of governors and managers decided to implement the new criteria in 2001. It is worth mentioning that, before this important modification, there were no provisions in the BVB listing rules referring to the share/paid-in capital or the market capitalization requirements of its listed issuers.

Originating from the OECD *Principles of Corporate Governance* (originally published in 1999; updated in 2004), the Code included incentives for listed issuers to raise their disclosure and transparency standards.

The T+ Tier was created as an “elite” section of the listed companies, which, in order to be promoted to this tier, had to:

- insert all Code provisions in their charters/statutes; and,
- remove from their charter and statutes all provisions that were contrary to the Code.

To be promoted to the T+ Tier, companies were not necessarily required to perform better, but they were required to provide better disclosure and be more transparent. The quasi-mandatory approach to implement the T+ Tier had its roots in the inadequacies of existing legislation. Neither the Romanian Companies’ Act nor the

Securities and Exchanges Act provided for special stipulations related to corporate governance principles, as the Code did. Since the Romanian legal system is based on civil law, any stipulations that were not expressly provided by the law are not mandatory. Under those circumstances, BVB was compelled to use the companies' charters/statutes as a means to impose the Code's provisions.

Third conclusion: While the corporate governance standards requested by investors were more or less incorporated into the Novo Mercado, Romania's Code and T+ Tier were developed and imposed by a market institution. This suggests that investor-driven, voluntary reforms are far more likely to succeed than any mandatory imposition of standards, as was the case with Romania's corporate governance initiative.

THE CODE'S MAIN PROVISIONS:

1. SHAREHOLDERS' RIGHTS

1.1 Proxy representation of shareholders in the General Meetings (GM) of shareholders by any natural or legal person.

The right to participate at the GM. The shareholders may participate at the GM in persona or in absentia, by a representative—natural or legal person—by means of a special proxy.

In 2000, according to the Companies' Act provisions, a shareholder could have been represented in the GM only by **another shareholder with a special proxy**.

This provision made it impossible for foreign shareholders/investors to express their views in such general meetings because it was difficult to find a trustworthy shareholder.

This provision sought to help foreign shareholders participate in the GM by allowing them to have their views expressed through a special proxy to a custodian or even a local broker.

1.2 Individual shareholders access to the GMs admitted based upon their ID

Access of individual shareholders to the GMs shall be permitted only upon presentation of their identification.

Though the Companies' Act was not imposing special documents that individual shareholders must present to access a GM, in practice, shareholders were requested to produce all kinds of useless documents, an irony given the market's paperless environment.

The Code was meant to address this problem.

1.3 Consultation of GM documents – at least 15 days prior to its date; photocopies on shareholder's request, charging a fair cost for the service

Documents consultation:

The Issuer is obliged to make available to the shareholders the GM documents to be debated for each item of the GM Agenda, at least 15 days prior to the GM convening date. Should a shareholder request copies of the GM documents, the issuer may impose on the shareholder only fair and nominal charges for copies.

The Companies' Act had no provision permitting the shareholders an opportunity to consult GM documents prior to the convening date. Moreover, when shareholders requested such documents, the companies' management imposed excessive charges.

The Code addressed the absence of laws in this area and unreasonable photocopying charges.

1.4 Convening of a GM by shareholders owning at least 10 percent of the outstanding shares, the proof of which is evidenced by the account statements of the company's share registry.

1.5 Once convened, such a GM would be required to debate the agenda proposed by the significant shareholders (those with at least 10-percent stake)

The General Meeting Agenda

(1) The GM convened as per art. 119 of Law no.v31/1990 (Companies' Act), as revised (by the shareholders owning at least 10 percent of the outstanding shares) should have, on the agenda, at least the issues requested for debate by such shareholders.

(2) The shareholders' request to convene the GM should be accompanied by relevant documents proving their minimum 10-percent holding of outstanding shares.

(3) The document proving the ownership should be the account statement issued either by a brokerage house or an independent registrar and should mention the ownership date.

The Companies' Act provided the possibility for significant shareholders (those holding 10 percent of the outstanding shares) to convene a GM, but, in practice, the issues they wanted to debate were either waived from the agenda or included but not debated.

Further, shareholders were requested to prove their ownership with authenticated documents.

The Code addressed these barriers.

1.6 When GM powers delegated to the Board of Directors (BoD), all decisions taken by the BoD should have a similar publication regime as the GM decisions;

Publication of the BoD decisions, adopted inside the GM power of attorney: For the BoD decisions adopted inside the GM power of attorney, as per art. 114 of the revised Companies' Act, it is mandatory to fulfill all publication formalities as legally provided for the GM.

The Companies' Act provided for the GM to delegate powers on various important decisions to the BoD. As a result, the general public and the market often learned about such BoD decisions long after they were taken and even implemented.

Under these circumstances, the Code asked for immediate publication of BoD decisions since many of these were price-sensitive and had an important impact on the share prices' fluctuations in the market.

1.7 If announced, dividends should be distributed only in cash and within a maximum of 60 days after the GM date approving their distribution.

Rights to dividends

Method and time of dividends' payment:

(1) The dividends are to be paid to the shareholders only in cash, proportionally with their participation in the paid-in share capital.

(2) The maximum payment time for dividends should be a maximum of 60 days after the GM date approving their distribution.

Dividends were announced at the GM—usually March/April—and paid very late or in a discriminatory manner (the state, which had an important stake in the companies was first on the distribution list). Also, some companies offered the in-kind dividends (e.g., textiles factories, food companies).

The Code requested fair treatment of all shareholders. Moreover, announced dividends must be paid in cash and not later than 60 days from their announcement.

1.8 At least one member of the BoD must represent the minority shareholders (when desired)

Rights to be represented in the BoD:

Representation of the Directors

Whenever desired so, the minority shareholders should have at least one representative in the BoD.

Minority shareholders were usually not represented in the BoD and, hence, could not gain attention for their views.

The Code imposed minority shareholder representation and even advocated the use of cumulative voting whenever minority shareholders expressed their intention to be represented in the BoD.

2. ACCOUNTABILITY OF THE BOARDS

2.1 At least one member of the Board of Directors should be independent

The Directors Independence:

- 1) At least one member of the Board of Directors should be independent.**
- 2) The independent director should be any individual cumulatively fulfilling the following conditions:**
 - a. for the last three years he/she was not a director or employee of the company or of any affiliates of the same;**
 - b. he/she is not currently receiving any other remuneration from the company or its affiliates, except for the directors' indemnity;**
 - c. he/she is not an associate, employee or significant shareholder (10 percent or more) in a consultant or similar company for the issuer or its affiliates or its important business partners apart from those legal**

entities which currently supply services on a national or local level and which tariffs are settled under the market conditions and are offered to all or the majority of their clients;

d. he/she has no major interest in a significant transaction or business relation of the issuer or its affiliates.

The Companies' Act had no provisions concerning the existence of the independent director and their relationship with the issuer.

The Code introduced this provision for the first time and advocated its importance for listed companies.

2.2 Avoidance of the conflict of interests by members of the Board of

Directors/Managers

The conflicts of interest:

The Directors and the Executive Managers of the issuers are forbidden to:

- **be, simultaneously, Directors or members of the Board of Managers, or executive officers or auditors in a competitors' company or in a company having the same type of activity;**
- **perform the same business or a competitor's one on his own account or on any third party account.**

The Companies' Act had no explicit provisions concerning the avoidance of the conflicts of interests.

The Code addressed this need.

2.3 Obligation to act in good faith and with utmost diligence by the members of the Board of Directors

The obligation to act in good faith and due diligence.

While exercising their competencies as directors, both the members of the Board of Directors and those of the Board of Managers should act in the company's interest, in good faith, and with utmost diligence.

The Companies' Act imposed some obligations on board members to act in good faith, the Code intended to enhance and stress such legal provisions.

5. ROMANIA'S SUCCESSES AND FAILURES WITH THE TRANSPARENCY PLUS TIER

When implemented, the Code was a revolutionary document because it imposed on listed companies conditions and obligations that were not in any existing laws.

The result of this implementation, however, has been a failure, given that only one company applied for promotion to the T+ Tier. Management of the recently privatized companies were quite reluctant to convene an extraordinary general meeting—as requested by the Companies' Act—in order to modify their charters/statutes and to explain to their shareholders why they would comply with more stringent rules and regulations that they were otherwise not obligated to do by law.

Why the T+ Tier Failed

An assessment by the Bucharest Stock Exchange:

In 2001, the BVB proposed a "Transparency Plus Tier," which required companies to comply with the recently developed Code. However, companies resisted requirements to introduce all of the Code's provisions into their company statutes. BVB's management analyzed why the T+ Tier failed and reached the following conclusions:

- The Romanian capital market was not really prepared to implement corporate governance standards
- The positive attitude of the local issuers towards corporate governance principles was overestimated
- While most companies declared their support towards observing corporate governance rules, very few were willing to introduce them in their charters
- The approach should be softened and tailored considering local economic conditions, history, and behavior
- The voluntary approach should have been used

Despite the obvious failure of the T+ Tier, BVB has recorded some notable successes. Although they did not apply to be listed on the T+ Tier, some of BVB's listed companies, especially the blue chips, started (after debating in a pilot group the pros and cons of the Code) to comply with some Code provisions. For example, some agreed to distribute their dividends in cash within 60 days of the

general meeting date. Pre-emptive rights were granted to existing shareholders, irrespective of cash or in-kind share capital increase. Cumulative voting¹ to appoint a minority shareholders' representative became a reality. Moreover, many Code provisions have been inserted into the capital market legislation that was adopted in 2002.

BVB has not been discouraged by the reluctance of some listed companies to implement corporate governance standards. It will continue working to promote them.

Fourth conclusion: While the BOVESPA Novo Mercado was a real success, the BVB T+ Tier was a failure. The main reasons for these two very different results were: the different development stage for each market, the highly varying degree of knowledge of the two markets' participants, the voluntary versus mandatory approaches in the implementation, and the forces that drove the implementation process.

6. WHERE WE ARE—SOME PERSPECTIVES

Since July 2004, Romania has had a new Capital Market Act unifying the legislation on the capital market and harmonizing these laws with the EU Directives. With the adoption of this new Capital Market Act, the whole market architecture had to be modified. As a consequence, BVB had to adopt new rules and regulations to respond to the new challenges and requirements of EU accession.

Since September 2006, BVB has a new Rulebook, the “BVB Code as a Market Operator,” to unify all former BVB rules and to respond to the new legislation. These new rules and regulations promote corporate governance principles and standards, which remain a permanent concern of the exchange. Following what almost all of the EU exchanges have done, BVB is implementing the “comply or explain” approach for 2008. Listed companies are obliged to consider the future provisions of the BVB Code and, when submitting their annual reports in 2008, they must include a “comply or explain” statement.

1 Cumulative voting allows minority shareholders to cast all their board director votes for a single candidate, as opposed to regular or statutory voting, in which shareholders must vote for a different candidate for each available seat. Theoretically, and when applied, cumulative voting increases prospects for minority shareholder representation on a board.

Fifth conclusion: Brazil's Novo Mercado and Romania's T+ Tier were both positive initiatives, undertaken respectively by the BOVESPA and BVB with the aim of removing barriers preventing the development of the two exchanges. Given the enormous differences in the development stage of the two exchanges and their markets, the results that each achieved were totally different. Novo Mercado was a success while the T+ Tier was a failure, albeit with some positive effects. However, for both exchanges, the process they had to develop to implement their initiatives was, first, an important learning process, which benefited each of them and, second, a growing up process, with both becoming more mature markets. In my opinion, for markets facing a situation comparable to that of the Brazilian market at the end of 1990's, the Novo Mercado model can bring similar positive results.

Reform Plans of Romania's Corporate Governance Institute

In 2003, the BVB established the Corporate Governance Institute (CGI), which works to raise Romania's managerial culture to EU standards and encourage companies to comply with the OECD *Principles on Corporate Governance*.

CGI will play an important role in drafting the new BVB CG Code, on the one side, and, on the other, in tutoring the listed issuers in better understanding both the Code and their obligations under the new rules.

The institute will be organizing:

- Training programs for managers/board members of privately-owned companies on going public and being traded on a regulated market
 - Publication of a "Directors' Guidelines"
 - Produce an "IPO Guide" and a "Guide on Shareholders General Meetings"
 - To continue the "tradition" of the last three years by organizing at the end of each June the BVB International Seminar on Corporate Governance. This seminar allows exchanges in the region to share experiences and expertise, including the development of corporate governance standards
- Training programs for managers/board members of the listed companies and then to extend these to all publicly-owned companies

TO LEARN MORE ONLINE

Corporate Governance Codes and Principles - Romania

http://www.ecgi.org/codes/code.php?code_id=101

Report on the Observance of Standards and Codes (ROSC). Corporate Governance Country Assessment for Romania.

April 2004. The World Bank Group.

http://www.worldbank.org/ifa/rosc_cg_rom.pdf

This Corporate Governance Assessment was completed as part of the joint World Bank-IMF Reports on the Observance of Standards and Codes (ROSC) and updates the findings of the Corporate Governance ROSC completed in 2002. It benchmarks the country's observance of corporate governance against the OECD Principles of Corporate.

Bucharest Stock Exchange

<http://www.bvb.ro>

Corporate Governance Institute for Romania

www.guvernatacorporativa.ro

In 2003, the BVB established the Corporate Governance Institute, whose aim is to raise Romania's managerial culture to EU standards and encourage companies to comply with the OECD Principles.

Organization for Economic Co-operation and Development *Principles of Corporate Governance*

http://www.oecd.org/document/49/0,3343,en_2649_34813_31530865_1_1_1_1,00.html

Download a copy of the OECD *Principles of Corporate Governance* in Arabic, Azerbaijani, English, French, German, Italian, Japanese, Polish, Portuguese, Russian, Serbian, and Spanish.

Romanian National Securities Commission (Comisia Națională Valoriilor Mobiliare)

<http://www.cnvmr.ro/en/index.htm>

RATING-BASED INDEXING OF THE ISTANBUL STOCK EXCHANGE:

LESSONS FROM NOVO MERCADO'S SUCCESS TO ADVANCE CORPORATE GOVERNANCE REFORMS

by Melsa Ararat and B. Burcin Yurtoglu

ABSTRACT

The authors examine the reasons why the Istanbul Stock Exchange's initiative to promote better corporate governance among their listed companies has failed to take off, in contrast to the Novo Mercado's success. After comparing the similarities and differences between Brazil and Turkey, the authors link Brazil's success to the influence of a broader range of investors (including pension funds and foreign investors) than is the case in Turkey. Further, "the collaboration of the private and public sectors, under the leadership of private actors, was a distinct feature of the Novo Mercado," the authors write. A weak legal foundation, few (if any) effective drivers of change, and the lack of sufficient incentives for the private sector are additional factors explaining why many companies in Turkey have yet to adopt corporate governance reforms. Having both a policy-making framework and policy reforms in place to support corporate governance reform is a key determinant of success, as the Novo Mercado experience illustrates.

1. INTRODUCTION

In the last 10 to 15 years, developed and emerging economies with weak corporate governance regimes have seen their securities markets lose listings and, hence, liquidity to international exchanges. Consequently, some exchanges began creating new "investor friendly" tiers and listing requirements. Others enacted reforms, including corporate governance codes, to protect minority shareholders. Most of these reforms chose "comply or explain" voluntary provisions and/or voluntary corporate governance codes, which provide more flexible, market-led regulations. Both reform efforts—voluntary listing tiers and codes—seek to share the control premium with minority shareholders as a means of encouraging equity investments.

In this commentary, we compare the objectives, processes, and outcomes of the different approaches adopted by the São Paulo Stock Exchange (BOVESPA) and the Istanbul Stock Exchange (ISE) for differentiating the "better governed" firms that have listed on their respective exchanges.

Maria Helena Santana's case study on the Novo Mercado of BOVESPA and Petra Alexandru's commentary on the Transparency Plus Tier (T+ Tier) of the Bucharest Stock Exchange (BVB) inspired us to review ISE's decision to reject the Novo Mercado model and, instead, employ the Corporate Governance Index (CGI) in Turkey.

Launched in late December 2000, the Novo Mercado attracted more than 30 companies within five years. In contrast, since its announcement in 2005, the CGI was able to attract the fifth qualified index member only towards the end of 2007. The main reason is that ISE-listed companies lack interest in complying with a comprehensive list of corporate governance provisions.

2. BRAZIL AND TURKEY: THEIR ECONOMIES, FINANCIAL MARKETS

Brazil and Turkey share similar development patterns and “democratic” traditions. Both belong to the French civil law tradition and suffer from an inefficient judiciary, weak enforcement, and the lack of a private litigation tradition.

Over the last 20 years, Brazil and Turkey have been subjected to similar economic vulnerabilities, resulting from a series of domestic and international shocks that led to suspension of democratic processes. Both countries had to cope with domestic debt, prolonged periods of both high inflation and unemployment, and failed efforts to achieve sustainable growth. Highly unequal income distribution remains a pressing problem in both countries.

Modern Turkey's Origins

Modern Turkey was founded in 1923 from the remnants of the Ottoman Empire. Until 1945, the state was the major economic player and subsidized private-sector development. A pro-market policy started to emerge after 1945, but the state remained heavily involved in its country's economy. In general, intervention by Turkey's government over the past years was oriented towards short-term, palliative measures instead of much-needed, sustainable solutions to the economy's structural problems. This led to an evolving relationship between the state and the business sector—one that generally lacked trust.

In 1980, Turkey's import substitution policies were replaced by an export-led stabilization and structural adjustment program. This program included the liberalization of capital markets, which was carried out between 1980 and 1989. The Capital Market Law was enacted in 1981, followed by the establishment of the Capital Market Board of Turkey (CMBT) in 1982.¹ After five years of preparation, the ISE was reorganized and reopened in 1986.

From 1990 to 2000, Turkey was hit by economic crises, during which time the inflation rate averaged 75 percent. Following the long-awaited European Union decision granting official candidate status in 1999, Turkey's worsening current account and the likelihood of a liquidity crisis forced the government to launch a major stabilization program with a stand-by IMF agreement. In late 2000, Turkey was eventually hit by a banking crisis, which was caused by liquidity problems, outright fraud, and related-lending issues. The developments after 2000 are summarized in this commentary's fourth section. The IMF continued to support Turkey's reforms with subsequent agreements signed in 2001 and 2004.

Prior to 2001, a long period of macroeconomic instability had reduced the probability of introducing corporate governance reforms in Turkey. Since 2001, the EU and the IMF both remained strong anchors for reform, which included restructuring the banking sector at a cost of US\$43 billion. In 2004, acknowledging the reform's success, the EC recommended that the EU start accession negotiations with Turkey.² The prospect of a sustainable, stable economy encouraged the government to continue with public-sector reforms, focusing on accountability, transparency (leading to improvements in the audit capacity and framework), and efficient tax regulations. Complementing the ongoing structural reforms in the public sector, CMBT initiated and led the process to improve the governance standards of listed companies.

1 Despite having some operational independence, CMBT is a semi-governmental agency overseeing the ISE. ISE's structure is similar to that of BOVESPA on paper. It is owned by its members and governed by its general assembly. However, ISE's operational independence has been questionable due to subsequent interventions from the government through CMBT, especially on fiscal matters. For example, the state-controlled listed companies did not fully comply with the guidelines and the privatization tenders made no reference to the guidelines.

2 Inflation fell to historic lows, political interference lessened, and the institutional and regulatory framework was aligned more closely with international standards, an important change towards a stable, rule-based economy. See: M. Ararat and M. Ugur. "Turkey, Corporate Governance at the Crossroads" in Chris Mallin (ed), Handbook on International Corporate Governance, Cheltenham, Northampton: Edward Elgar, 2005.

Key Comparisons between Brazil, Turkey

In the early 2000s, the Brazilian equity market was characterized by relatively low liquidity, high costs of capital, and limited growth in new capital. Compared to its Latin American neighbors, Brazil's equity market was large, but market capitalization was concentrated in a small number of large companies.

A comparison of the Brazilian and Turkish financial markets is provided in Table 1, using time series data from 1990 to 2004. The ratio of stock market capitalization to GDP starts in 1990 at about the same level for both countries. While this ratio in Brazil exceeds Turkey's in most years since 1990, by 2000, the difference becomes substantial, averaging nearly 39 percent for Brazil and 24 percent for Turkey. On the other hand, there was substantially less trading in Brazil than Turkey, as is indicated in the third and fourth columns (Brazil 13 percent vs. 32 percent in Turkey from 2000 to 2004).

While a private bond market is virtually nonexistent in Turkey, this market's capitalization relative to GDP was about 10 percent of Brazil's GDP in the 1990s. The size of the public bond markets in both countries is much higher. Turkey has a slightly larger bond market relative to GDP in the last three years of the sample period (1990-2004). The other proxies for gauging the status of financial market development at that time are the financial institutions' ratios of private credit (see Table 1). These ratios suggest that Brazil has a more developed financial market. Both countries' markets, though, were flooded with public borrowing, resulting in very high interest rates.

There were relatively few IPOs in both countries. Turkey had on average 24 IPOs per year from 1990 to 2000, but this number is much lower (seven per year) after 2000 (see Table 2).

Table 1: Structure of Financial Systems in Brazil and Turkey, 1990–2004

	Stock Market Capitalization / GDP %		Stock Market Total Value Traded /GDP %		Private Bond Market Capitalization / GDP %		Public Bond Market Capitalization / GDP %		Private Credit by Deposit Money Banks / GDP %		Private Credit by Deposit Money Banks and Other Financial Institutions / GDP %	
	Brazil	Turkey	Brazil	Turkey	Brazil	Turkey	Brazil	Turkey	Brazil	Turkey	Brazil	Turkey
1990	6.71	8.50	1.21	3.87	0.00	0.37	0.00	5.11				13.02
1991	7.24	11.57	3.29	5.68	0.00	0.30	0.00	5.81				13.84
1992	11.30	8.11	5.25	5.15	1.26	0.53	0.94	7.70	19.11	12.76	24.22	13.85
1993	16.51	13.20	13.11	12.98	3.36	1.12	7.41	9.64	22.92	12.80	27.64	13.71
1994	26.39	22.89	19.96	16.69	8.29	1.28	14.61	13.18	28.33	12.48	34.18	13.39
1995	24.10	12.61	11.25	30.41	10.89	0.53	17.93	10.57	30.11	11.94	36.80	12.74
1996	23.60	14.07	14.45	20.35	10.40	0.37	23.77	12.92	28.07	15.04	33.66	15.86
1997	29.30	24.12	25.00	29.64	9.90	0.05	29.89	14.86	27.52	17.36	32.40	18.21
1998	26.51	23.79	18.65	34.23	11.74	0.03	35.01	16.80	29.39	18.21	34.55	19.08
1999	36.79	39.67	16.50	44.17	15.21	0.00	49.82	21.92	29.19	18.13	35.13	19.03
2000	37.95	46.38	16.78	89.95	8.78	0.00	40.72	24.65	27.17	17.99	34.87	18.77
2001	40.98	40.94	12.81	53.75	9.91	0.00	50.69	48.46	27.25	18.55	35.58	19.37
2002	33.91	22.38	10.46	38.41	9.98	0.00	47.24	48.24	26.47	13.46	34.10	14.26
2003	35.64	21.42	11.94	41.50	9.40	0.00	41.45	48.62	26.69	13.42	34.31	14.17
2004	46.91	27.72	15.47	48.68	10.71	0.00	45.11	51.65	26.23	16.40	33.89	17.09

Source: IFS Statistics.

Table 2: The Development of the Stock Market in Turkey, 1990–2006

	Number of Listed Companies	IPOs	Total Trading Volume (Millions US\$)	Funds raised through IPOs (Millions US\$)	ISE-100 Index US\$ based:1986=100)	Stock Market Capitalization (Millions US\$)
1990	110	35	5,854	985.31	642.63	18,737
1991	134	24	8,502	319.63	501.50	15,564
1992	145	13	8,567	94.42	272.61	9,922
1993	160	17	21,770	152.45	833.28	37,824
1994	176	25	23,203	270.48	413.27	21,785
1995	205	30	52,357	246.78	382.62	20,782
1996	228	25	37,737	167.92	534.01	30,797
1997	258	31	58,104	420.38	982.00	61,879
1998	277	20	70,396	383.35	484.01	33,975
1999	285	10	84,034	87.41	1,654.17	114,271
2000	315	36	181,934	2,809.53	817.49	69,507
2001	310	1	80,400	0.24	557.52	47,689
2002	288	4	70,756	56.5	368.26	34,402
2003	285	2	100,165	11.30	778.43	69,003
2004	297	12	147,755	482.58	1,075.12	98,073
2005	304	9	201,763	1,743.96	1,726.23	162,814
2006	316	15	229,642	930.50	1,620.59	163,774

Source: Istanbul Stock Exchange, Annual Factbooks 1990-2006

3. OWNERSHIP PATTERNS: DIFFERENCES, SIMILARITIES IN TWO PERIODS—THE 1990s AND 2000-2006

Both countries exhibit similar ownership patterns: businesses are organized into industrial groups and are largely controlled by families. Academics Sylvia M. Valadares and Ricardo P. C. Leal analyze the direct and indirect ownership structures of listed Brazilian companies in 2000 and reported that:³

³ Silvia M. Valadares and Ricardo P.C. Leal. 2000. Ownership Structure of Brazilian Companies. Available at SSRN: <http://ssrn.com/abstract=213409> or DOI: 10.2139/ssrn.213409 .

- 1) The ownership concentration is high, with the largest direct shareowner holding averaging 41 percent of equity capital.
- 2) There are frequent violations of the one-share-one-vote rule.
- 3) Both non-voting shares and cross-ownership structures are used to achieve this violation. However, the role of non-voting shares is much more pronounced in Brazil.
- 4) Corporations are the most common investor category at the direct level. Families turn out to be the ultimate owners.

Similar patterns have been reported for Turkey in 2000 (a detailed account is provided in Table 3):⁴

- 1) Ownership concentration in Turkey is similar to that of Brazil, with the largest direct shareholder averaging 47 percent of equity capital.
- 2) In Turkey, there are frequent violations of the one-share-one-vote rule based on the use of share groups, which can exercise privileged control rights collectively.
- 3) Voting privileges and pyramids are both used to bypass the one-share-one-vote rule. Pyramids (as opposed to non-voting shares) are much more responsible for the wedge between voting and cash-flow rights.
- 4) Corporations and holding companies are the most common shareholder categories at the direct level. Families ultimately control about 80 percent of the listed companies primarily using pyramids.

Even as late as 2006, there is some evidence that the boards in both countries are ineffective and only play advisory roles.⁵

For all the above reasons, there is also evidence that both countries suffer from low valuations for their firms. This large discount is due to the concentrated shareholding structures and deviations of cash-flow rights from voting rights. There is a large premium for controlling blocs, indicating a high level of private benefits for the controlling stake and expropriation of minority shareholders.

4 B. B. Yurtoglu, "Ownership, Control, and Performance of Turkish Listed Firms." *Empirica* 27, no.2 (2000): 193-222. B. B. Yurtoglu, "Corporate Governance and Implications for Minority Shareholders in Turkey." *Journal of Corporate Ownership and Control* no.1 (2003): 72-86.

5 Ararat, Orbay, and Yurtoglu (2006) op. cit.

While the similarities between the two countries are far more pronounced than the differences, select key differences can be of substantial importance from a corporate governance reform perspective.

One such difference concerns the identity of minority shareholders. Local institutional shareholders, mainly pension funds and mutual funds, owned significant minority stakes in Brazil. As of 2000, these holdings amount to a little less than four percent at the direct ownership level and to almost five percent at the ultimate level.⁶

While Brazil has a much longer history with privately managed pension funds, Turkey does not (they were introduced in 2000) so these funds play very limited roles. Pension funds controlled a portfolio totaling YTL295 million in 2004, with shares comprising about 13.32 percent of these holdings. The total portfolio increased to YTL2.7 billion in 2006, but the fraction in equity investments declined to 8.6 percent.

Foreign investors constitute an important investor category in Brazil. These investors have on average eight percent of the direct and 14 percent of the indirect holdings.⁷ These percentages are much lower in Turkey, where foreign shareholders have sizeable stakes in only 20 of the 218 listed companies (See Table 3).

This difference is mainly due to the relatively early start of privatization in Brazil, which led to a significant presence of foreign investors in BOVESPA in the 1990s. In Turkey, privatization led to similar results only after 2003.

Another important difference between Brazil and Turkey is the existence of different mechanisms used to increase the wedge between cash-flow and voting rights.

As of 2001, the use of non-voting preferred stocks is common in Brazil, allowing controlling shareholders to exercise control with less than one-third of their cash-flow rights. Minority shareholders did not have voting rights at that time.

6 Valadares and Leal, "Ownership Structure." (2000).

7 Valadares and Leal, "Ownership Structure."

Table 3: Ownership and Control Structure of Turkish Listed Companies

PANEL A: DIRECT OWNERSHIP

Identity	Number	Largest Shareholder			CR3 (Sum of the three largest shareholders)			Dispersed		
		Mean	Median	Std.Dev.	Mean	Median	Std.Dev.	Mean	Median	Std.Dev.
Holding Company	96	47.62	46.23	17.66	65.80	68.84	15.31	30.6	27.90	14.35
Non-financial companies	47	47.84	44.38	17.20	67.31	66.89	14.60	28.9	26.10	13.71
Financial companies	5	49.25	51.00	13.09	58.62	55.96	11.81	39.2	40.79	14.07
Families	42	34.11	28.20	22.64	52.22	54.10	24.20	38.3	29.30	25.96
Foreign companies	20	67.77	69.28	19.22	81.20	83.98	13.38	17.5	16.03	13.45
State	5	67.25	65.76	29.93	70.02	65.76	26.27	23.0	25.00	20.29
Miscellaneous	3	63.87	83.16	34.02	68.42	83.85	27.37	31.2	15.44	27.68
Total	218	47.63	45.47	21.07	64.89	67.23	18.85	30.5	26.11	17.96

PANEL B: ULTIMATE OWNERSHIP

Identity	Number	Voting Rights			Cash Flow Rights			Wedge		
		Mean	Median	Std.Dev.	Mean	Median	Std.Dev.	Mean	Median	Std.Dev.
Families	173	66.10	66.23	21.54	54.04	56.61	22.84	7.47	1.00	49.84
Foreign companies	21	67.30	70.00	20.73	65.31	68.56	19.67	1.04	1.00	0.16
State	7	65.83	55.62	22.57	65.83	55.62	22.57	1.00	1.00	0.00
Miscellaneous	17	65.35	65.57	19.42	42.56	34.49	22.84	2.18	1.75	1.95
Total	218	66.15	66.30	21.20	54.61	55.92	22.98	6.23	1.00	44.44

PANEL C: THE FREQUENCY OF DUAL CLASS SHARES AND CORPORATE CHARTER ARRANGEMENTS

Number of Companies with	
One share one vote	125
Two types of shares with different voting rights	66
More than two types of shares with different voting rights	19
Special treatment in the distribution of earnings	24
Special treatment in the election of the board of directors	82
Special treatment in the election of the supervisors	41
Preemptive right to buy new issues of stock	13

Panel C of Table 3 shows the frequency of multiple shares (which are not necessarily non-voting shares, but offer some privileges to controlling shareholders) and other privileges reserved for controlling shareholders in Turkey.

Source: Yurtoglu (2003) and Orbay and Yurtoglu (2006)

By comparison, controlling shareholders of Turkish companies use pyramidal structures and nomination privileges to increase their control. Most of the ISE-30 companies predominantly have common shares. Pyramidal structures are not common in Brazil, whereas non-voting shares are not common in Turkey. In 66 of the 218 listed industrial companies, there are more than two types of shares, while the frequency and extent of pyramidal structures is much more pronounced. Non-voting “shares” do exist in Turkey, but they are not part of the equity. So-called “founder shares” are coupled with “vouchers,” which allocate additional cash-flow rights to the founders without them having to provide an additional investment. In general, founder shares entitle the owners to a certain percentage of the company’s profits, independent of whether the general meeting of shareholders decides to distribute dividends. The use of founder shares may partly explain the low-dividend performance of Turkish companies.

One can also observe some differences in the propensity of Brazilian and Turkish firms to list abroad. In 2000, significant Brazilian companies listed abroad. That year, the volume traded on the US market by 28 Brazilian companies (representing 5.6 percent of the 495 companies total on the BOVESPA) amounted to one-third of the entire volume traded on BOVESPA. In contrast, the effect of foreign listings

was much less significant in Turkey since there was only one large issuer on the New York Stock Exchange and another on the London Stock Exchange at that time.

Another important difference deals with de-listings at BOVESPA and ISE. It was possible to de-list from BOVESPA, which experienced a significant number of de-listings in the late 1990s. Turkey's stock-exchange regulations make it practically impossible to deregister from ISE.⁸

Yet another difference concerns the development of non-governmental initiatives in both countries. Whereas such initiatives date back to 1995 in Brazil with the founding of IBGC (Instituto Brasileiro de Governança Corporativa), similar efforts started much later in Turkey with the launch of TUSIAD's Corporate Governance task force in 2001, the Corporate Governance Forum of Turkey (CGFT) at Sabanci University in 2002, and the Corporate Governance Association (TKYD) in 2003.

4. CHANGES AFTER 2000: NOVO MERCADO—WHY OR WHY NOT?

As described above, ISE experienced problems similar to those faced by BOVESPA before its launch of the Novo Mercado. There were no IPOs, trading volume was at historic lows, and issuers were complaining about compliance costs. ISE was exploring the idea of encouraging IPOs by establishing a separate market for small to medium-size companies with *less strict criteria*.⁹ A separate market tier with tighter corporate governance requirements did not appeal to ISE for the following reasons:

- a) Only the largest and most liquid companies which target international institutional investors would be interested in, and capable of, complying with stricter criteria. The main market would be heavily discounted and dwarfed if these firms were to be excluded.¹⁰
- b) There were reputational risks; issuers might not be interested in the index since there were no explicit signs of interest from investors.

8 This resulted in "listed" companies, whose traded shares diminished to less than one percent.

9 CMBT was not supportive of this idea.

10 The 30 companies that were considered to be the potential constituencies of a corporate governance segment constituted 80 percent of the market value.

- c) Operational difficulties and resource requirements for a separate market would be substantial; ISE and CMBT both had resource shortages.

When ISE considered the Novo Mercado, the approach was found lacking in two principal respects in 2000: first, its listing criteria seemed too simplistic; and, second, Novo Mercado had only one listing and did not appear to be a success.

The Corporate Governance Committee established by the CMBT had considered four alternatives to promote voluntary improvements in the governance of listed companies:

- indexing based on ratings by independent rating agencies;
- a separate market;
- indexing based on CMBT ratings; and,
- award systems.

CMBT wanted to act quickly. A separate market tier of the ISE would require a longer preparation period, whereas an index could be launched as soon as there was a sufficient number of qualifying companies. CMBT ratings qualification was not supported for various reasons: methodology development would need skills and expertise that CMBT did not have; and, maintaining the index would require permanent resources, including a substantial commitment of staff time.

By 2003, the credit-rating agencies Standard & Poor's and Fitch Ratings were actively promoting corporate governance scoring services in Turkey. Deminor, a Brussels-based corporate governance rating firm (later acquired by Institutional Shareholder Services, which is now RiskMetrics), was also active in the market. CMBT opted to use independent rating agencies (or their licensees). This was considered to be a faster, less costly, and less risky approach than a separate market segment like the Novo Mercado.

CMBT's decision was based on the assumption that the corporate governance scoring methodologies would converge as the quality of corporate governance becomes an important investment criteria for global investors. CMBT believed that compliance with its Corporate Governance Guidelines would indicate compliance with internationally accepted standards. Another assumption was that the Nationally

Recognized Statistical Rating Organizations (NRSRO) would offer corporate governance rating services in Turkey. Since NRSRO activities are strictly monitored by the U.S. Securities and Exchange Commission, local monitoring would not be needed and compliance with international corporate governance rules would be presumed. Accordingly, the rating agencies and qualified companies would appeal to global investors.¹¹

Subsequently, the NRSROs unanimously decided to incorporate corporate governance assessments into credit rating methodologies and stopped offering corporate governance scoring as a separate service. Based on various informal discussions with NRSRO representatives, our view is that corporate governance “ratings” exposed the international rating agencies to significant reputational risks without an attractive return. CMBT responded by releasing the requirement of an “international rating methodology” for certifying rating agencies. Since then, two local agencies have been established.

Since the launch of the Corporate Governance Index and the 2005 decree, three Turkish companies commissioned corporate governance rating agencies. Isbank used Core in 2005, while both Dogan Yayin Holding and Vestel commissioned ISS in 2006 and 2007.

According to market participants, the three companies’ scores did not have credibility for two reasons. First, all three companies received very high scores (8 – 9 out of 10), but the reports did not seem to capture the issues that mattered most to local investors. One reason explaining this outcome is the rating agencies’ use of foreign analysts to meet CMBT’s requirements. (According to the CMBT rating decree, analysts must be certified by passing a CMBT exam and they must have three years of corporate governance rating experience with an international firm. This sharply limited the pool of qualified local analysts.) The foreign analysts were not familiar with the local context. Their published reports could not capture the complex relations within Turkish business groups and the influence exercised by controlling shareholders through pyramidal structures and informal mechanisms since the guidelines are designed to focus on single companies. In fact, one of the published corporate governance rating reports notes that their score reflects

11 In the United States, the Securities and Exchange Commission (SEC) permits the use of credit ratings from certain credit-rating agencies for certain regulatory purposes. Those agencies whose ratings are permitted to be used for these regulatory purposes are referred to “Nationally Recognized Statistical Rating Organizations” (or “NRSROs”). The SEC grants NRSRO recognition, administers these agencies’ registration, and surveils their activities. Examples of NRSROs include Standard and Poor’s and Fitch Ratings.

“compliance with the guidelines” and is not to be confused with a corporate governance rating.

Corporate Governance Guidelines Launched

ISE remained an observer when CMBT launched the Corporate Governance Guidelines in 2003. Based on the OECD's Corporate Governance Principles, these guidelines provide recommendations for listed companies' governance on a “comply or explain” basis. The guidelines consist of more than 100 provisions grouped under four headings: Shareholder Rights; Disclosure and Transparency; Board Responsibilities and Processes; and, Stakeholder Relations. CMBT's efforts were neither blocked nor wholeheartedly supported by the government since the focus of the Turkish government's investment promotion strategy had been on attracting foreign direct investments.¹² Since this guidelines' public initiative was poorly coordinated,¹³ the private sector remained skeptical. CMBT spent considerable effort to establish a private-sector dialogue, but they could only engage with salaried managers rather than the owner-managers (controlling shareholders). The process was not effective because consultation is not part of the Turkish political traditions. Further, there is a lack of trust between the state and the private sector, as explained earlier. Pension funds were just starting, foreign ownership in listed companies was negligible, and the media was not yet interested in corporate governance matters. The CGFT,¹⁴ a new initiative, was the main private entity that actively supported CMBT's efforts.

During the year following the guidelines' launch, the response from listed companies in adapting the voluntary principles was disappointing. Very few companies made any reference to CMBT's guidelines in their 2003 annual reports. In order to improve compliance in 2004, CMBT introduced mandatory reporting based on a standard report template. Starting with the 2004 annual reports, listed companies had to outline how they were in compliance with CMBT's guidelines, using the CMBT

12 For example, the state-controlled listed companies did not fully comply with the guidelines, and the privatization tenders made no reference to the guidelines.

13 Unfortunately, the lack of coordination between public offices and agencies has been a persistent problem in Turkey. For example; while CMBT was busy with improving the regulatory framework for listed companies, the Banking Regulatory and Supervisory Agency (BDDK) was also working on improving the corporate governance regime of the financial institutions. Meanwhile, a committee established by the Ministry of Justice had been working on a draft Commercial Code for years. The cooperation among BDDK, CMBT, and the commission set up by the Ministry of Justice was limited. Nevertheless, the draft recognized CMBT's regulatory authority on corporate governance for all joint stock companies.

14 A research and advocacy center hosted by the Faculty of Management at Sabanci University.

template. The report had to explain which provisions the issuers had complied with and which ones they hadn't done so (the reasons why and the actions they planned to comply). Unfortunately, the quality of compliance reports in the 2004 annual reports and the guidelines' implementation were both disappointing, according to a CMBT survey. These efforts had created some awareness, but there were neither strong incentives nor sanctions to compel compliance.

The guidelines' legal foundation was weak. Although drafting of the modern company laws had started as early as 2000 in Turkey, the guidelines preceded modernization of the commercial code. The guidelines were envisaged as a road map for improvements in shareholders' legal protections. The draft Commercial Code, which was expected to be enacted in early 2006, introduced a completely new framework and pro-market approach for joint stock companies to support the guidelines. However, the draft was blocked by the opposition in parliament.¹⁵

In Brazil, banking reforms preceded the new Company Law (2001) and the voluntary corporate governance code (2002). Although the Company Law was subject to political interventions and changed considerably before enactment, it provided a better foundation for regulatory and incentive-based systems.

After much reflection on ways to promote corporate governance ratings as a market-based alternative to regulations, CMBT announced a Corporate Governance Index (CGI) at the end of 2004. Those listed companies that complied with the guidelines, as determined by independent rating agencies, would be included in the index. The idea of differentiating "better governed" companies by including them in a separately tracked index was not fully supported by ISE, but, the exchange followed the regulator's instructions.¹⁶ ISE's March 2005 press release announced that the CGI would be launched as soon as five companies qualified. Qualification requires that a company receive a corporate governance score of six out of 10 by the rating agencies. Qualified companies are entitled to a 50-percent discount on listing fees, which in most cases covers the rating agency's costs.

¹⁵ The basis of opposition was that the draft mandated that all joint stock companies use IFRS and engage external audit. The Social Democrats argued that this would increase the dominance of Big Four audit firms and have a negative effect on the role of independent accountants, who are not familiar with IFRS. The government and the opposition were forced to reopen parliamentary discussions in March 2007 as a response to criticism from TUSIAD.

¹⁶ The reluctance is obvious when the Turkish and English Websites of ISE are compared: the English version does not mention CGI, whereas it is mentioned at the top of the Turkish Website.

5. REFLECTIONS ON THE DRIVERS OF REFORM: THE CORPORATE GOVERNANCE INDEX EXPERIENCE AND ITS OUTLOOK

The main drivers for Novo Mercado seem to be from within: demands from institutional shareholders and foreign investors to revitalize BOVESPA and stop the flight of Brazil's best companies to NYSE. In contrast, the drivers for reforms in Turkey were external (IMF stand-by financing and the EU), and the main actors were public institutions and the government. In Brazil, private actors were involved and provided thought leadership. Above all, Brazil had in place a policy framework that supports corporate governance and guided policy reforms, another key factor in Novo Mercado's success.

The Novo Mercado was led by BOVESPA, a non-profit institution owned by brokerage firms. But, unlike the CMBT case, it was officially supported by other private actors and beneficiaries from its inception. The Brazilian Institute of Corporate Governance (IBGC) and the Private Sector Advisory Group (PSAG)¹⁷ lent their credibility and prestige to the idea within the network of major global institutional investors. Another private actor was the National Association of Investment Banks (ANBID), which mandated that its members could only lead underwriting offerings for issuers that are registered, at a minimum, on Novo Mercado Level One. The support from the private sector was complemented by public entities, such as the Brazilian Development Bank (BNDES), the Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários, CVM), and the agency responsible for oversight of Brazilian pension funds (SPC). The collaboration of the private and public sectors, under the leadership of private actors, was a distinct feature of the Novo Mercado.

Turkish market players have been actively engaged in discussing potential benefits and shortcomings of the index approach since its original announcement. The general views of Turkish market participants, experts, and academics were expressed in a workshop organized by CMBT in 2006.

¹⁷ The Private Sector Advisory Group of the IFC Global Corporate Governance Forum is comprised of more than 70 of the world's most prominent experts on corporate governance. Advisors volunteer their time and expertise to help implement better corporate governance practices in developing and transition countries. Members include corporate executives, board members, investors, lawyers, accountants, and financial journalists from developed and developing countries. Learn more: www.gcgf.org.

Here is what they said:¹⁸

- a)** They do not expect CGI to meet its objectives, even if five companies eventually qualify.
- b)** The CGI and its selection criteria should be reviewed.
- c)** Although CMBT provided a weighting for each of the four headings of the guidelines, the respective weight of individual provisions under one heading is left to the rating companies to decide. This approach may introduce inconsistencies. The criteria for qualification and the weighting of each criterion should not be left to rating agencies but should be specified by CMBT.
- d)** The idea of a separate market based on additional listing requirements, such as the Novo Mercado with its corporate governance levels, should be reconsidered.

Moreover, since the launch of the guidelines and the index, foreign ownership in ISE-listed companies has significantly increased due to both direct investments and portfolio investments resulting from rising demand for Turkish assets. Turkey experienced a significant number of mergers and acquisitions where control has been transferred to foreign shareholders with premiums reaching 100 percent in some cases. High control premiums led to high prices for mandatory bids, which were eagerly accepted by minority shareholders. As a result, the percentage of traded shares was drastically reduced and the burden of complying with ISE regulations was hardly justified.

BOVESPA's Novo Mercado approach captures the key issues identified specifically by investors. Therefore, the better market performance of Novo Mercado companies comes as no surprise, although further research is needed to understand the long-term effects on returns.

The Novo Mercado case provides convincing evidence that consultation with major institutional investors on the requirements and soliciting their support for reform, including the CGI, is a very important step. It is also a step that may be more challenging since Turkey lacks the business and political traditions that Brazil

¹⁸ <http://www.spk.gov.tr/ofd/KurumsalYonetim/index.html?tur=calistay>

had, which include experience in building consensus. Cultural differences, then, are among the most important determinants of success in ushering in market-led corporate governance reforms. After comparing the similarities and differences between Brazil and Turkey, Brazil's success is linked to the influence of a broader range of investors (including pension funds and foreign investors) than is the case in Turkey. Those investors in Brazil participated in a policy-making process that drove corporate governance reforms, including the Novo Mercado.

Recommendations for Istanbul Stock Market's Corporate Governance Index

We recommend combining the ISE and Novo Mercado approaches. In its current form, a company that receives a score of six or more out of 10 can be included in the index regardless of the specific guidelines that it meets or doesn't meet. In our view, inclusion should be subject to full compliance with relatively few key criteria (related with *sine qua non* issues such as shareholder rights and accountability of insiders). These criteria should be identified in consultation with international and local institutional shareholders. A corporate governance assessment report may be required to provide further insight into a company's level of compliance with more than 100 provisions of the guidelines.

Those companies that do not like the idea of exposing themselves to outside scrutiny by involving a CG rating agency may signal commitment to good governance by announcing their compliance.

We provide the following set of requirements to determine if companies qualify for the index:

- a) Minimum free float of 25 percent at any one time
- b) Minimum 500 shareholders at any one time
- c) Disclosure of ultimate ownership at the level of real persons
- d) Disclosure of ownership of "groups of shares" with board nomination rights
- e) Requirement to disclose board nominations before the general assembly if there exist shareholder agreements on nomination rights
- f) Filing of all shareholder agreements with ISE immediately after signing
- g) No founder shares

- h) A commitment to external audit of all transactions between related parties exceeding a predefined value
- i) General assembly approval for mergers and major transactions, including sale of assets above a certain value
- j) A maximum wedge (deviation of cash flow rights from control rights)
- k) No non-voting shares
- l) Disclosure of direct or indirect ownership interests exceeding five percent up to the ultimate level of real person shareholders
- m) Disclosure of contracts with related parties—e.g., above one percent of company's net worth, based on a clear definition of related parties by the regulator

TO LEARN MORE ONLINE

Corporate Governance Codes and Principles – Turkey

http://www.ecgi.org/codes/code.php?code_id=117

Corporate Governance of Turkey at Sabanci University

<http://cgft.sabanciuniv.edu/eng>

CGFT is a research and advocacy center hosted by Sabanci University Faculty of Management focused on empirical research.

Report on the Observance of Standards and Codes (ROSC).

Corporate Governance Country Assessment for Turkey. April 2004. The World Bank Group.

http://www.worldbank.org/ifa/rosccg_turkey.html

This Corporate Governance Assessment was completed as part

of the joint World Bank-IMF Reports on the Observance of Standards and Codes (ROSC). This report benchmarks the country's observance of corporate governance against the OECD *Principles*.

Istanbul Stock Exchange

<http://www.ise.org>

Turkish Corporate Governance Association

www.cogat.org

In 2003, the Turkish Corporate Governance Association was established; its mission is to raise awareness by training the various corporate players on how to enable good corporate governance based on existing principles, with the main issues in the Turkish business environment being board effectiveness.

Turkish Securities Regulator

<http://spk.gov.tr>

Turkish Stock Market Investors Association (BORYAD)

<http://www.boryad.org/English.htm>

Established in April 2001, Turkish Stock Market Investors Association is the first and only civil organization that represents the rights of more than two million investors.

**Organization for Economic Co-operation and Development
Principles of Corporate Governance**

http://www.oecd.org/document/49/0,3343,en_2649_34813_31530865_1_1_1_1,00.html

Download a copy of the OECD Principles of Corporate Governance in Arabic, Azerbaijani, English, French, German, Italian, Japanese, Polish, Portuguese, Russian, Serbian, and Spanish.

Corporate Governance in Turkey: A Pilot Study

http://www.oecd.org/document/6/0,3343,en_2649_37439_37490374_1_1_1_37439,00.html

The 2006 report examines the extent to which the OECD Principles have been implemented in Turkey.

REFERENCES

- Alexandra, P. 2008. "Novo Mercado versus Transparency Plus Tier – A Mirror Image." *Focus*, No: 5, *Novo Mercado and Its Followers: Case Studies in Corporate Governance Reforms*. Washington, D.C.: Global Corporate Governance Forum.
- Ararat, M. and M. Ugur. 2003. "Corporate Governance in Turkey: An Overview and Some Policy Recommendations." *Corporate Governance: The International Journal of Business in Society* 3 (1): 58-75.
- Ararat, M. and M. Ugur. 2005. "Turkey, Corporate Governance at the Crossroads," In Chris Mallin (ed), *Handbook on International Corporate Governance*, Cheltenham, Northampton: Edward Elgar.
- Ararat, M. and M. Ugur. 2006. "Does Macroeconomic Performance Affect Corporate Governance? Evidence from Turkey." *Corporate Governance, an International Review* 14 (4): 325-39.
- Ararat, M., H. Orbay, and B.B. Yurtoglu. 2006. Board Structure in Turkish Listed Companies, working paper, CGFT: Sabanci University.
- OECD. 2006. *Corporate Governance In Turkey*. Paris: OECD.
- Orbay, H. and B. B. Yurtoglu. 2006. "The Impact of Corporate Governance Structures on the Corporate Investment Performance in Turkey." *Corporate Governance: An International Review* 14 (4): 349-363.
- Standard and Poor's and CGFT. 2005, 2006. *Transparency and Disclosure of Turkish Firms, Survey Report*. Available at: www.governance.standardandpoors.com .
- Santana, M. H. 2008. "Novo Mercado," *Focus* No. 5. Washington, D.C.: Global Corporate Governance Forum.
- Valadares, Silvia M. and Ricardo P.C. Leal, 2000. *Ownership Structure of Brazilian Companies*. Available at SSRN: <http://ssrn.com/abstract=213409> or DOI: 10.2139/ssrn.213409.
- Yurtoglu, B. B. 2000. "Ownership, Control, and Performance of Turkish Listed Firms." *Empirica* 27 (2): 193-222.
- Yurtoglu, B. B. 2003. "Corporate Governance and Implications for Minority Shareholders in Turkey." *Journal of Corporate Ownership and Control* (1): 72-86.

OUR MISSION:

Established in 1999, the Global Corporate Governance Forum is an IFC multi-donor trust fund facility located in the Corporate Governance and Capital Markets Advisory Department. Through its activities, the Forum aims to promote the private sector as an engine of growth, reduce the vulnerability of developing and transition economies to financial crises, and provide incentives to corporations to invest and perform efficiently in a socially responsible manner.

The Forum sponsors regional and local initiatives that address the corporate governance weaknesses of middle- and low-income countries in the context of broader national or regional economic reform.

OUR FOCUS:

- Raising awareness, building consensus
- Disseminating best practices
- Sponsoring research
- Funding technical assistance and capacity-building

OUR DONORS:

- Canada
- France
- Luxembourg
- The Netherlands
- Norway
- Sweden
- Switzerland
- International Finance Corporation

OUR FOUNDERS:

- World Bank
- Organisation for Economic Co-operation and Development



Global
Corporate
Governance
Forum





Global
Corporate
Governance
Forum

2121 Pennsylvania Avenue, NW
Washington, DC 20433 USA
Tel: +1 (202) 458 1857
Fax: +1 (202) 522 7588
cgsecretariat@ifc.org
www.gcgf.org