Boards of Directors of Publicly-Held Companies in Brazil: profile and implications for minority shareholders

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We analyse the profile of the boards of directors of 142 Brazilian publicly-held companies in 1999. Directors were divided into four distinct categories, following Bhagat and Black (2000 Working Paper no. 143, Columbia Law School) criteria for the US market. Our survey analyses the degree of independence of directors in relation to their respective controlling shareholders. Our results indicate that the controlling shareholders' representatives largely dominate the boards. One intriguing finding is that minority shareholders do not use the mechanisms at their disposal to elect directors. There seems to be low interest by non-controlling shareholders in participating in shareholders' meetings, and consequently in selecting representatives for the board of directors. This could partly be explained by the lack of proxy voting mechanisms.

Keywords: Board of directors, voting mechanisms, Brazil

Introduction

Corporate governance has been receiving increasing attention from the academic and corporate communities, focusing on topics such as the power and responsibility of boards of directors, rules related to hostile acquisitions of shareholding control, institutional investors' participation in company management, and remuneration policies for senior managers and directors. The structure and composition of the board of directors is one of the central issues of the discussion. This paper analyses the supervision role of these boards from a standpoint of their composition.

In recent years, academics, professional associations and multilateral organisations have analysed the profiles of these boards' members. The basic objective is to identify whether the "ideal" structure and composition for these boards are to increase their supervisory activity and to make them more efficient.

A proxy for efficiency and supervisory capability is related to the number of independent directors sitting on the board. Independent directors are expected to perform their activities without being influenced by the company senior management or by a specific group of shareholders, particularly the controlling shareholders. The basic assumption is whether these directors will perform their roles to the benefit for all shareholders.

This paper takes as a benchmark for the effectiveness of the supervisory activity an estimate of the ratio of "independent" professionals sitting on publicly-held company boards in Brazil. The study identifies the non-controlling shareholders' participation in this process, measuring the use of mechanisms by minority shareholders to appoint their directors. One intriguing finding is that minority

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shareholders do not use these mechanisms to elect directors.

Background

Ownership concentration and evidence of expropriation

During the second half of the 1990s, La Porta *et al*. (1998, 1999) developed several studies regarding the differences among several domestic capital markets. One of the main focuses of those studies was the identification of the causes and consequences of stock ownership concentration, particularly in countries with a lower degree of minority shareholder protection. One of their basic conclusions was that the differences in the degree of protection for shareholders' rights may explain some contrasts (such as ownership concentration, liquidity in the secondary market, the relative size of each market, dividends policies and access to external financing).

The degree of protection, however, varies according to the characteristics of several legal frameworks (and the effectiveness of their use) in each country. Empirically, the authors demonstrated that shareholders are better protected against expropriation events promoted by senior managers or controlling shareholders in countries with legal systems such as common law – particularly the USA and UK.

Analysing a sample of 49 countries, the authors suggested that the concentration of stock ownership is negatively related to the protection of shareholders' rights, which means that countries with better protection are more likely to present a greater diffusion of corporate ownership (La Porta *et al*., 1998). By classifying countries according to their different legal systems, they showed that those with a legal tradition inherited from French civil legislation (a category in which Brazil is included) exhibit a higher degree of ownership concentration.

A later study by these same authors also demonstrated that those countries with less efficient protection mechanisms for shareholders have a greater number of companies under family or state control, and in the former case, without a significant separation between ownership and management (La Porta *et al*., 1999).

Berndt (2000) agrees that rights derived from stock ownership can be classified into two distinct types: control rights, which effectively imply the possibility of appointing the company's managers, and rights to participate in the distribution of dividends. In countries with greater shareholding concentration, both are secured only for controlling shareholders. Those not belonging to the controlling group have rights only to dividends and other gains paid by the company, according to legal requirements.

Bebchuk *et al*. (2000) point out that these types of rights, noted in countries with shareholding concentration, operate through three distinct mechanisms: establishing differentiated voting rights to several stock classes or types, creating pyramidal shareholding structures, and reciprocal participation among companies.

One of the results of the dissociation of rights, whether or not related to the concentration of stock ownership, is called in the literature "private benefits of control", which means benefits appropriated by the controlling shareholder that are not distributed to other shareholders. According to Bebchuk (1999), this is an incentive to less diffusion of voting rights in countries where minority shareholders have low protection.

Several studies find evidence of the occurrence of this type of benefits appropriation by the controlling shareholder, e.g. Barclay and Holderness (1989) and Nenova (2000). The latter makes the following comment, after analysing 1997 data for 18 countries:

> *In Brazil, for example, the controlling shareholder can keep only one-sixth of the total stock with dividends rights [half plus one common share, which can reach one-third of the total capital], but actually extracts (or expects to extract) 37.5 per cent of the company's value. The additional benefit expropriated represents an increase of 21 per cent on one-sixth of the shares corresponding to dividends.*

Staying with the Brazilian case, evidence on the occurrence of this wealth appropriation by the controlling shareholder is also presented by Cunha (2000), who shows some premiums paid by acquirers of controlling stock, in relation to the market value of the shares before sale. For example, the premiums paid by the shareholding control of Freios Varga in 1998, Arno in 1997 and Metal Leve in 1996 were 337, 253 and 289 per cent, respectively.

According to Cunha, such extra premia reflect the idea that gains from control stock ownership exceed the benefits of a possible diversification of their investment portfolios.

The necessity of control and the board of directors

The possibility of expropriation by controlling shareholders of company value focuses the discussion on the requirement of monitoring managers' activities. Mechanisms are required to restrain the creation of rules that benefit exclusively controlling shareholders,[1] so shares can be priced by the market in an equitable way.

Countries with shareholding concentration, such as Brazil, do not depend on external control of the company's management mechanism, in which senior managers are pressured by the stock market value, and by the subsequent risk of hostile acquisition of the shareholding control. In these countries, with controlling shareholders holding the majority of the voting power, and with secondary markets with less liquidity, what is left to minority shareholders is the alternative of using mechanisms for the internal control of management – preponderantly performed by the board of directors.

Boards exist in all publicly held companies, with deliberative functions, and constituted by professionals elected by their own shareholders. Their attributions are described in Article 142 of the Brazilian Corporate Law (#6.404, from 15 December 1976), which specifically outlines the control performance, highlighting the supervision of directors, accounting books and papers, agreements, and any other acts related to company management.

Due to this supervision of directors' performance, the discussion about the need of independence for directors has been gaining importance. In the USA, the major concern is to establish boards in which the majority of members are independent from management – the so-called "external directors". This concern is due to the fact that, in the USA, conflicts occur mainly because of interest divergences between senior managers and shareholders. Therefore, if the majority of the board of directors are executive directors, its freedom to perform as an effective control on the company management would be jeopardised.

However, countries such as Brazil are characterised by shareholding concentration, and in this environment, according to Valadares and Leal (1999–2000), the major conflicts occur in the relationship between controlling shareholders and minority shareholders. Therefore, in these countries, the board's "independence" would depend upon the greater or lesser influence of controlling shareholders on their members, and not necessarily upon the influence of executives, as in countries where stock ownership is diffused.

Brief literature review

In the USA, most studies have focused on the structure of boards of directors, and in most cases the effects of different structures on the boards have been analysed. The results vary considerably.

Rosenstein and Wyatt (1990) find evidence of above-average returns for shares in companies that have disclosed information on the selection of external directors (i.e. those who are not members of the management), between 1981 and 1985. However, Weisbach (1988) finds evidence of a significant correlation between bad performance of companies, and subsequent dismissal of the main executive, in institutions whose boards are dominated by external directors.

Other studies present similarly conflicting results. Byrd and Hickman (1992), for example, show that there is a non-linear correlation between the presence of external directors and the creation of value for shareholders. Accordingly, they measured the market reaction to 192 public offerings between 1980 and 1987. The correlation becomes negative when the proportion of external directors exceeds 60 per cent of the board seats. Agrawal and Knoeber (1996), by analysing the performance of 400 American companies between 1983 and 1987, identified a negative and significant correlation between the major presence of independent directors and the return on the market share price.

Surveys conducted outside the USA on this subject have been strongly influenced by the American methodology, which differentiates "internal" and "external" directors. The most detailed one is presented by Mônaco (2000), who analysed 647 companies registered in the Brazilian Securities Exchange Commission, with data from 1996. His results were the following:

- 70.4 per cent of the directors were considered "external" (not part of the board) and 29.6 per cent "internal";
- on average, boards comprised 5–6 members;
- evidence was found suggesting that the existence of voting syndicates was associated with the major presence of "external" directors, and that public companies had boards with a greater number of members.

Mônaco also agrees that the high predominance of external directors indicates a strong potential for independence from the board in relation to executives. However, it must be considered that the separation between internal and external directors is originally based on the idea that conflicts of interest occur between executives and shareholders. By measuring the participation of internal directors, it is possible to estimate the degree of freedom granted to those responsible for company management. A board whose majority of members are internal directors may indicate that supervision is less intense – or that these directors would be supervising their own activities.

However, as previously mentioned, in countries with shareholding concentration the conflict occurs especially between controlling and minority shareholders. The differentiation between external and internal directors loses its analytical power, since shareholders who are part of the control group are nevertheless included in the group of external directors.

It is necessary, therefore, to identify the degree of freedom given to members of the board of directors, in order to create mechanisms to protect the interests of all shareholders, and not only a particular group – in this case, the controlling shareholders.

The problem with the freedom given to members of the boards is referred to by the main "Brazilian Code of Best Practices". The Brazilian Institute of Corporate Governance, for example, states that:

> *The main reason for the importance of independence is to avoid conflicts of interest. The majority of the Board must be constituted by independent Directors . . . Directors must seek for independence as much as possible in relation to the shareholder, shareholding group or interested parties who might have appointed them for the position.* (IBGC, 2000)

Following the same principles are the *Cadbury Report*, produced in England (Lodi, 2000), and OECD (Organisation for Economic Cooperation and Development), as a recommendation for their country members (Bovespa, 2000). Both also highlight the significance of including "independent" directors, aimed at reducing the occurrence of conflicts of interest.

The survey

The database

With the objective of studying companies with active participation in the stock market, the survey was based on the sample of Brazilian companies with shares traded in stock exchanges in 1999 representing at least 0.01 per cent of the total financial volume traded in that year. The annual report of Brazilian National Organisation of Stock Exchanges (Confederação Nacional das Bolsas de Valores, 2000) was used as a source of information on the domestic market share trading, which includes operations from the then existing nine stock exchanges. Shares traded outside of these exchanges were disregarded, since they represent only a very small proportion of the total volume traded in the stock market.

From this initial group of 154 companies, 12 companies were excluded, due to their delisting as publicly held companies (4), incorporation by others also belonging to the group in the study (4), and data not available on directors' profiles (4). After such adjustments, the group was reduced to 142 companies.

The identification of the board of directors' members was made through an analysis of the Annual Reports of 1999, sent by publicly held companies to the Brazilian Securities Exchange Commission. They include a list of all members elected after board meetings held in the first half of 2000. Such reports are compulsorily presented by companies up to the end of August each year, and contain information on the structure of the board of directors and the management, besides data on previous and present professional performance of members of each of these two boards.

The latter information made it possible to classify each of the directors in each of the four categories presented below, whose distinguishing criteria followed the model used by Bhagat and Black (2000),[2] with some adjustments:

1. director representing the control group: individual who holds a seat either on the board or in the management of companies belonging to the control group, or who is a member of the family holding the control, or member of the government that holds or is part of the control;
2. "internal" director: professional who takes part both on the board and in the management of the company at the same time;
3. "affiliate" director: professional who has one of the following characteristics: former employee of the controlling company or group; employee or beneficiary of the pension foundation sponsored by the same company; representative elected by employees; former member of the government or public company which is part of or holds the control; or managing director or director of the controlled company or its affiliates;
4. "other" directors: professionals with no apparent links with the company or its controlling shareholders.

The identification of members in the fourth category ("other") is a complex task, but all professionals who could not be classified in any of the other three divisions were classified as belonging to this category. This broad classification is due to the practical impossibility of identifying professionals who are genuinely independent in relation to the management or to the control group. Therefore, the percentage of "other" directors identified reflects only partially the real independence of the board, and this should be borne in mind when considering the results obtained from the analysis.

In principle, in internal discussions of the board, directors are free to make their own decisions, provided they respect limitations established by law. The position assumed by each of the participants depends basically on their convictions regarding the subject in question. Their analyses and their decisions depend exclusively on their opinions about the subjects being discussed. It seems reasonable to suppose, however, that independent directors have more freedom, for they are less likely to be under pressure by the controlling shareholder or the management. Therefore, the assumption for the classification criteria is based on the concept that "independent" directors will probably perform a more efficient job in defending the share value of non-controlling shareholders, compared to the expected role of those directors classified as "affiliate", "internal" or "controlling".

For each of the companies, the following variables were also identified: participation of controlling shareholders in total capital and total voting shares, number of members of the board of directors, type of control (through a single economic group or through a voting syndicate), source of controlling shareholders (domestic group, foreign group, state control or mixed control), existence of depositary receipts abroad, and total asset value. Such data have also been obtained from Annual Reports of 1999, and from Financial Reports of 31 December 1999, made available by the Brazilian Securities Exchange Commission.

The structure of boards of directors

The results in Table 1 were obtained after the classification of the 1,058 directors in each of the four categories proposed, and after the relative participation of each of them was calculated.

At first glance, the significant participation of directors from the "controlling" group is not a surprise, since the voting stock ownership is effectively concentrated – see Siqueira (1998) and Valadares and Leal (2000) for this evidence. Therefore, it would be predictable that controlling shareholders would hold a major number of seats on the board, for the effective entitlement of control benefits, referred to above.

It should also be observed that the "other" category represents only 21 per cent of the total, a percentage which suggests that local companies are largely not in compliance with the *Cadbury Report* and *Instituto Brasileiro de Governança Corporativa* (IBGC, Brazilian Institute of Corporate Governance) recommendations. This issue must also be considered in connection with the fact that the percentage of "other" directors is not correspondent to the number of truly independent ones, given the limited information on the directors' profiles.

For the sake of comparison, for a sample of 934 American companies in 1991, Bhagat and Black (2000) found a ratio of 64 per cent of independent directors, 12 per cent of affiliates and 23 per cent of internal directors (their study did not include the "controlling" category).

The distribution of companies according to the range of participation of external directors on the board is shown in Table 2.

It can be noted that the proportion of "other" directors is less than one-quarter in more than half of the companies surveyed. Only 16 companies, from a group of 142, would comply with IBGC's recommendation on independence, if all directors belonging to the "other" category may be considered independent ones.

Table 1: Category of board directors of 142 companies surveyed

Category	% of total directors
Controlling	49
Internal	10
Affiliate	20
Other	21

Table 2: Participation of "other" directors on boards (142 companies)

% of independents in each board	Number of companies studied	% of companies studied
Less than 24.9	83	58.5
From 25 to 49.9	43	30.3
From 50 to 74.9	15	10.6
Above 75	1	0.6

In these circumstances, the nature of the board supervision may be jeopardised, since the category of independent directors is usually a minority in most companies studied. Only in 16 companies (11.2 per cent of the sample) does the "other" category represent the majority (or at least half of the total members).

Since the management control in Brazil is performed almost exclusively through the internal system, this board structure indicates that the efficiency of the board monitoring activity may be seriously jeopardised by the likelihood of benefits expropriation by controlling shareholders.

Unfortunately, due to the use of different classification methodologies, results cannot be directly compared to the ones obtained by Spencer Stuart (2000), Mônaco (2000) and Ventura (2000), who also analysed the profiles of Brazilian boards of directors.

Company characteristics

The division of directors into several categories, and their influence upon certain characteristics of each of the companies, are shown in Table 3.

The use of chi-square for data with three variables, with a level of significance of 5 per cent, did not allow the rejection of the null hypothesis for the source of control, and the type of control (single or voting syndicate). Such confirmation has been supported by the use of a log-linear saturated model, also with a level of significance of 5 per cent, with the use of all possible interactions and effects.

A multiple regression model was also applied, considering the three qualitative variables mentioned above, and the addition of four quantitative variables (number of members of the board, total assets value, participation of the controlling shareholders in the total capital and with voting shares). In this model, a proportion of "other" directors on the board was used as a dependent variable. However, results were not satisfactory, with low levels for R^2, even after the use of several variable changes, univaried analyses and the use of stepwise procedures.

Minority participation and the use of cumulative vote

First, it is worth quoting § 4° of Article 141 of the Corporate Law:

> *§ 4° – If the number of board members is less than 5 (five), it is allowed for shareholders who represent 20 per cent (twenty per cent) of the voting capital, at minimum, the election of one of the board members, according to § 1°.*

Thirty of the 142 companies under analysis have boards of directors with fewer than five members (usually with three or four members). However, among these, only 18 have controlling shareholders whose share of the regular voting capital is less than 80 per cent. This means that only these 18 companies would have the possibility of appointing a board member in accordance with § 4° of Article 141.

Table 4 presents a comparison of the distribution of directors by categories, among the 18 companies subject to selection of board members through the mechanism provided by § 4° of Article 141, and the remaining companies of the sample.

The statistical analysis of results allows the identification of the degree of correlation among categories. It can be clearly observed that companies subject to the use of voting power according to § 4° of Article 141 have a lower participation of the "other" category of directors, which is surprising. A greater participation of this category would be expected,

Table 3: Influence on the characteristics of companies by the board of directors structure

Measured variable	Company's characteristics	Number of companies	Controlling directors (%)	Affiliate directors (%)	Internal directors (%)	"Other" directors (%)
Use of "depositary receipts"	Do not use	88	48.4	18.1	10.9	22.7
	Use	54	48.8	22.7	9.7	18.8
Source of control	Domestic	55	49.6	22.2	9.0	19.1
	Foreign	50	48.7	13.5	12.8	25.0
	State	17	37.6	32.0	11.2	19.1
	Mixed	20	56.9	14.4	8.3	20.4
Type of control	Single control	101	44.7	20.8	11.5	22.9
	Voting syndicate	41	56.5	18.2	8.1	17.3

Table 4: Influence of the possible participation of minority shareholders on the board of directors' structure

Director category	Companies subject to §4° of Art. 141	Other companies
Controlling	64.4%	47.6%
Affiliate	6.8%	20.7%
Internal	11.9%	10.3%
"Other"	16.9%	21.3%
Number of companies	18	124

assuming that minority shareholders effectively used their opportunity to appoint a board member.

The analysis is more complex when we consider the number of seats available on the boards in each of the 18 companies. For those with three or four seats on the board, the proportion of the "other" category members would represent 33 per cent for boards with three seats, or 25 per cent for boards with four seats, as the minority shareholders would elect at least one director.

Of the 18 companies included in this category, 13 have three seats on the board, whereas five others have four seats. Therefore, the estimated percentage of members of the board elected by minority shareholders for these 18 companies would be 30.78 per cent (25 per cent $\times$ 5/18 + 33 per cent $\times$ 13/18), a proportion considerably above the 16.9 per cent effectively observed.

However, the participation of minority shareholders of common shares is not limited according to § 4° of Article 141. The cumulative voting mechanism can still be used, according to the beginning of the same Article. It represents the allocation, for each share, to a number of votes corresponding to the number of seats on the board. In this way, contrary to regular voting, in which each ordinary share corresponds to only one vote, in this category each share gives the right to, for example, five votes if this is the number of available seats on the board.

This mechanism, according to Carmo (1988), "is an efficient way of allowing organized minority shareholders to be represented on the board of directors. It can turn into a risky mechanism to majorities when they are diffused and disorganized."

In fact, through a voting strategy concentrating on one or more candidates, minority shareholders can be represented on the board, which would be difficult without this mechanism due to the high concentration of shares in the controlling group's hands. The election results would depend basically on the number of shares owned, the number of positions to be appointed, and the way of distributing votes among candidates.

The rules concerning the adoption of cumulative voting are established by the Brazilian Securities and Exchange Commission (CVM). Accordingly to CVM Instruction #282, and by observing the capital of the 142 companies included in the sample, and comparing the percentage of the common stock according to CVM rules, we can infer that for 134 companies the minimum percentage required for the use of cumulative voting would be 5 per cent. This means that the percentage initially in compliance with the law, 10 per cent of the total common shares, would be reduced to half when CVM's rules are applied.

Considering CVM's rules, another five companies would have 6 per cent as the necessary percentage, one would have 7 per cent, and the remaining two, 8 per cent of the regular voting shares. However, not all the companies have an amount of shares corresponding to the percentage required by CVM Instruction distributed among minority shareholders.

It can be observed that, in 30 cases, the amount of common shares held by controlling shareholders does not allow the requirement for cumulative voting. Accordingly, the group being studied was reduced to 112 companies. Correspondence through electronic mail was sent to all of them, addressed to the Director of Relations with Investors, in which the use of cumulative voting in board meetings held in 2000 was questioned.

Only 43 companies responded to the questions (38.39 per cent of the total number of companies contacted), which, to a certain extent, limits the possible conclusions that can be drawn from such a low number of answers. From these 43 companies, only three (7 per cent of respondents) stated that the use of cumulative voting had been required by minority shareholders.

Final considerations

The survey demonstrates that boards of directors are largely dominated by controlling shareholders' representatives (49 per cent), with less participation of "other" professionals (21 per cent). There is also evidence of influence on the source of control and the way control is performed according to the distribution of board members in the proposed categories.

Companies that could count on minority representatives, either by cumulative voting, or by the direct selection of a member for the board by shareholders with at least 20 per cent of the voting stock, did not exhibit a major participation of "other" directors either. This is an intriguing result as the minority shareholders do not use their mechanisms at their disposal to elect directors.

Such results may suggest that the average structure of boards of directors does not allow the full performance of its role as supervisor of executives' activities, particularly regarding the relation between controlling and minority shareholders. Apparently, measures taken by executives to benefit controlling shareholders, which would be subject to deliberation by the board of directors, would find little opposition since the majority of directors are associated with controlling shareholders.

The survey also showed that legal mechanisms that allow the selection of minority shareholders' representatives do not necessarily result in significant changes to the structure of the board of directors. There seems to be low interest by non-controlling shareholders in participating in shareholders' meetings, and consequently in selecting representatives for the board of directors. This could partly be explained by the lack of proxy voting mechanisms.

A possible recommendation would be to enlarge the possibilities for appointing board members by non-controlling shareholders. It would be worthwhile to evaluate the advantages of increasing the participation of institutional investors in issues associated with company governance. Entities that establish rules, such as stock exchanges and other self-regulatory bodies, could also establish listing requirements which would include changes in election mechanisms.

Notes

1. Company wealth transfer mechanisms can assume many different forms: transactions between the company and controlling shareholders in unfavourable conditions, the use of privileged information, paid capital with overestimated assets, incorporation of controlling companies, and others. For further details, see Johnson *et al*. (2000).
2. The change from Bhagat and Black's (2000) criteria consisted of the inclusion of the controlling shareholders category, which does not exist in the authors' model, since they analysed the American case.

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