OCDE – Discurso – Mauro Rodrigues da Cunha, presidente da Amec

Initially I would like to thank the organizers of the Task Force and of the Roundtable for the opportunity to, once again, share with you Amec's vision of the challenges surrounding the development of our equity markets. I will try to be very objective given the limited time available, and the large number of issues I would like to put on the table here.

My first message to you is that, despite all of the efforts of recent, we still do not have an equity market in Brazil. This may sound preposterous, given the sheer size of B3 and the statistics that highlight it as the largest market in the region. But this reflects the past, not the future. We still have less than 350 companies, in a country where thousands could tap the public equity markets. Our market is dominated by behemoths, especially financial, industrial or state-owned, that do not reflect the diversity of our GDP. This **SLIDE** compares the composition of our GDP and the Ibovespa. It clearly shows that when you buy the latter, you are not buying the former. More worryingly, some of the most dynamic sectors of our economy, such as agribusiness, IT and Health and Education are grossly underrepresented in the index.

IPOs take place in leaps and bounds – emulating the proverbial "chicken flight". It seems that once the market reaches a certain level, the IPO machine in investment banks crank up and start producing deals. The result is a few large companies producing "pre-packaged" offers. Many times management doesn't even know what the bylaws say. I have an example of my own: I have recently been invited to join the board of a company ONE WEEK prior to the IPO. This is an indicative of shallow governance, hurriedly put together just to complete the "IPO kit".

We have seen numerous examples of companies hopelessly unprepared to be public – both in terms of culture and of internal controls – selling shares worth hundreds of millions, only to squander the capital in ill-fated or short-term oriented decisions.

And more recent deals shed light on the promiscuous nature of the book building process – a spectacle where well-intended regulation produce unintended consequences in the form of silence periods, asymmetric information – such as presentation of materials that investors cannot take home – and broker buzz on the "heat" of the order book. Investors recent that.

These problems point to a number of action items to develop healthier capital markets. Companies need to be better prepared for the transition from private to public. We praise and support B3's efforts to go upstream with their education efforts, and hope the initiatives shown by Cristiana be maintained and increased.

Going public is a deep-rooted change that has to be worked from the factory floor to the office of the chairman, reaching the controlling shareholders. Banks need to be more stringent on the quality of companies they bring to market, and more transparent in the pricing of offers. This is an inconvenient truth that is rarely addressed.

IPOs are thwarted not only by these "supply side" issues, but also by "demand side" concerns. I will not waste our time listing the travails of minority shareholders in Brazilian companies –

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I've done that a lot already. But I can summarize them in one equation: 1% ≠ 1%. If you buy 1% of a company, you should get 1% of the value – no questions asked. No matter how obvious this may seem, it is far from the reality in Brazil. We have seen too many cases of control premia, related party transactions, abusive compensation, fraud and other strange animals that have resulted in financial investors receiving a much smaller share of value than their stake in the company. Perhaps the clearest basket case was Oi, in which the former controlling shareholders left with billions and minority shareholders were left with a bankrupt entity. Petrobras, Aracruz, Usiminas, PDG, Eletrobras, Gerdau, EBX, UOL… the list goes on and on. As long as investors perceive that they do not get their fair share of value, they will drive valuations down, and that will preclude any sustainable cycle of IPOs in Brazil.

Solving this equation involves many dimensions. It is crucial, though, to make it clear that disclosure is not enough. Enforcement, education and stewardship are necessary companions. We have had advances in disclosure. Implementation of IFRS and the advent of the Brazilian Corporate Governance Code are welcome tools to allow investors to "price" ESG risks. Along the same line it is important to praise CVM's efforts to improve disclosure of management compensation, risk factors and internal controls. In the case of the former it is depressing to see companies going to court to avoid disclosing basic facts about compensation – certainly much less than the norm in more advanced markets. Concerning the two latter, we highlight CVM Instruction 552, which is leading companies to rethink their risk management systems – not only the disclosure thereof. It is a clear case of the tail wagging the dog – regulation inspiring behavior.

But there are own goals too. Form over essence is a constant threat in any initiative to improve disclosure in Brazil. And there the attitudes of investors, companies and regulators need to change. Investors should stop consuming press releases while ignoring more substantial disclosure such as Formularios de Referencia, board minutes and bylaws. Companies need to exercise the IBGC principle that "transparency is more than the obligation to inform… it is the willingness to inform". Legalese in official filings defeat the purpose of disclosure regulation, and there is unfortunately still too much of it. And regulators should frame their decisions to focus on essence, not form.

This is particularly worrisome in the case of accounting, with the implementation of IFRS. The system is principle-based, and therefore gives management lots of discretionary power in relation to its numbers. Amec has called for a rethink of the governance of accounting to reign in this discretionary power. Regulators should enforce this characteristic of the system, or we will be stuck with the worst possible scenario: a flexible system, in which what is not clearly "prohibited" is therefore allowed. There are already some questionable precedents in that direction.

The same holds true for the enforcement of conflicts of interest. This Roundtable has repeatedly discussed the problem, especially – but not exclusively – in the context of related party transactions. Still, problems in this area continue to happen in Brazil. A strong system of the "majority of the minority" needs to be enforced. And it clearly needs to be BEFORE THE FACT,

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not after the fact. As we have painfully learned year after year, enforcement after the fact is equivalent to a GET OUT OF JAIL FREE card. And here are just a few examples thereof.

The Issues Paper discusses private arbitration as a partial solution for all that. I must state for the record that our members are frustrated with private arbitration. In fact, we may have ended up worse off than with the previous reliance on CVM and courts. Private arbitration is expensive and opaque. New legislation making it mandatory basically eliminated the possibility of recourse for small investors. Also, being opaque, decisions in arbitration do not create precedent and actually open the way for corruption, in the form of green mail. If a settlement in not material in the accounting sense, management can settle with anyone without benefitting shareholders generally. Equity market arbitration needs to be reformed urgently in Brazil. It is not working.

Amec also shares a bitter-sweet aftertaste in relation to the reform of the Novo Mercado. As well summarized in Paragraph 60 of the Issues Paper, despite the herculean efforts of B3's team, important items to maintain the credibility of the Novo Mercado were lost in the process. The prohibition of shareholders agreements determining directors votes and the creation of "superpreferred shares" are just two examples.

It is a shame to see companies that were supposed to be aligned with best practices vote down important updates in rules either due to a manichaeistic view of "I win, you lose" or due to an incapacity to understand or even consider the proposals until the very last minutes. One cannot help but think that maybe too many companies made the cut to be a part of the Novo Mercado, and that it would be beneficial to them and to the market if they left. Another idea is the creation of an "Association of Novo Mercado companies", really interested in preserving the good will that their segment once represented.

But investors have their share of the blame too. Precious few of them engaged with invested companies to discuss the changes in the Novo Mercado. This is indicative of a broader problem: lack of proper stewardship on the part of institutional investors. This, in turn, is the result of a poor understanding of their fiduciary duties, lack of client or regulatory pressure and investment in ESG integration in investment processes.

To fix this problem, Amec has launched its Stewardship Code in October 2016 and, more recently, the Implementation Handbook to assist signatories in their journey to better stewardship. We currently have 16 signatories. We hope to multiply this number, and count on our Roundtable partners to spread the word. The Code is already having an impact – even among non-signatories, who are looking at it as a compass to review their internal policies.

Proper stewardship will lead to better corporate governance, and thus to better decisions and better companies. Amec hopes to foster dialogue between companies and investors to improve the process of board building. The dreaded concept of the "representative of controlling shareholders" or "representative of minority shareholders" is not conducive to creating a diverse, relevant group of individuals to lead company. To achieve that, many steps are necessary: proper stewardship on one hand, and openness to dialogue on the other.

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Board evaluations need to be carried out and their results should frame the dialogue, as correctly put by Robeco in its 2016 Stewardship Report. CVM Instruction 561, which regulates distance voting already has a framework for such dialogues prior to shareholder meetings, but unfortunately investors and companies are not yet taking advantage of it.

However, one of the most encouraging things going on for the development of the Brazilian market are the changes at BNDES. The largest institutional investor in the country, with close to BRL 100 billion in stakes in listed companies, BNDES is implementing several new policies and practices which, in our opinion, amount to true stewardship. The limitation of subsidized credit and a strategic view of the complementarity between the development bank and capital markets translate into a significant change that is impacting our market as we speak. It is crucial that ongoing efforts at Avenida Chile be applauded and supported.

In my opinion, the solution of the problem of financial inclusion, raised by Chairman Barbosa and integration, raised by the Issues Paper passes through a rethink of the institutional investor framework. Investment and pension funds are the most efficient vehicles to provide equity exposure to individuals, as well as to stimulate savings – another challenge of the region. Still, many times institutional investors face an uphill battle to fulfill their role. Investment funds face higher taxation than individuals. Brazil subsidizes dividends and heavily tax nominal capital gains – making long-term investors pay taxes over inflation. And pension funds are locked into a regulatory structure that doesn't stimulate healthy risk taking. It is no surprise that our biggest pool of capital – closed pension funds – is dying. I recently participated in the annual event of the Pension Fund Association, and the need for reform is perceived as urgent to all involved.

Worse, Anbima data indicates that the exposure of investment funds to equities is less than 4%. The same is true for pension funds (7% ex-Previ) – who in theory are the longest-term investors in the country. Incentives for institutional investors need to be rethought, so that they become the vehicle for individuals to get access to the equity market.

In the process, investment funds can become a powerful tool for market integration. It would be much easier to facilitate cross border risk taking by these institutions than creating complex intermediary solutions to allow for individuals to get market access, along the lines mentioned by Roberto Belchior.

On the other hand, and finalizing my comments, there are two issues of utmost importance that need to be addressed. And here the Federal Government must play an important role. Firstly, the CVM must have adequate resources to fulfill its mission. Budget constraints have, year in and year out, reduced the regulator's resources. In late 2015 the government increased fees on investment funds and managers by up to 241%. The Finance Minister justified this increase by stating that low fees "put in jeopardy the financing of the [CVM] activities". Well, if that was true, the government should be considered guilty of putting in risk the CVM activities, since 100% of the additional revenues were channeled to the Treasury, and not to CVM. The regulator's authorized expenses in 2016 were the same as in 2015, in real terms.

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In 2016 20% of CVM positions were vacant given lack of resources or of new exams to admit new employees. Its discretionary expenses today are identical to that of 2010: BRL 30 million (USD 9.4 million). In 2016 CVM's capital expenditures – which include computers, servers, structure and much else – was BRL 5 million (USD 1.6 million). In 2015 that amount was a laughable BRL 20 thousand!

As long as the government starves CVM of resources, we cannot build a healthy capital market. Finally, the last item I wanted to highlight is reparation of damages. I will not extend myself in this topic, for a single reason: it is nonexistent in Brazil. With few and small exceptions, investors suffering atrocities in the capital markets have been unable to pursue compensation of damages. Again, there are two fronts to fix this problem: one is on the regulator side.

Amec has proposed that a recent Provisional Measure made it a condition for plea bargains or leniency agreements that investors were compensated. This idea was echoed in articles by CVM's former chairman Marcelo Trindade and the former Executive Secretary of the Ministry of Finance Bernard Appy. Unfortunately, neither Congress or the Government listened, and another opportunity was missed.

Still, CVM's own regulation suggests that reparation of damages should be a pre-condition to plea bargains. This condition should be taken more seriously.
Finally, on the other side, investors should do their homework. Stewardship requires proper escalation when necessary. Yet, institutional investors have been quite passive in pursuing their rights in courts – either due to a misunderstanding of fiduciary duties or to a lack of faith in the system. Both problems need to be addressed.
Thank you.

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