The adoption of special listing segments by the São Paulo Stock Exchange in the year 2000 was an important step forward for the Brazilian equity market. The Bovespa exchange introduced the Novo Mercado which is a premium listing tier with voluntary corporate governance standards going above and beyond the provisions of the law in protecting the rights of minority shareholders vis-à-vis controlling shareholders. Its official aim was to enhance shareholder rights and board accountability. Simone Azevedo, a founding partner and chief editor of Capital Aberto magazine (www.capitalaberto.com), looks at the developments of the Novo Mercado and examines its future challenges.

The year was 2000, and the capital market was floundering. Market capitalization of companies traded on the stock market had evolved since the beginning of the 1990s, but the value had never surpassed 35% of the country’s GDP. By 1999, primary share issues did not amount to more than US$ 1.5 billion. There were several reasons for the decline. After years of an economy closed off to imports, investments and, consequently, funding resources for companies were in short supply. Loans provided by the BNDES, the federal government’s development bank, represented an excellent alternative for the entrepreneurial class, and the companies, in this context, had little incentive to go public. Investors, in turn, charged a high premium for investing in companies, thus elevating their cost of capital. It was a vicious and perverse circle that exasperated the advocates of a working capital market for an economy that aimed to be more vibrant.

This was the context in which the BM&FBovespa called in economists and lawyers to formulate a study that, in December 2000, would give rise to distinctive levels of governance at Bovespa — among them the special corporate governance section named Novo Mercado [New Market].

Novo Mercado: Will it ever cease to be “new”?

Article by Simone Azevedo
The authors of the project concluded that corporate governance would be key for minority shareholders to gain more respect, whilst attributing lower risk to Brazilian shares and, accordingly, offering more attractive prices to share issuers. Thus, three distinctive segments were created: Level 1, Level 2 and the Novo Mercado. The first was focused on transparency demands. The second included the rules of the first and added important rights, such as tag along and the settlement of disputes by arbitration. The third, the Novo Mercado, took the provisions of the second level and added one crucial demand: all shares issued were to be common shares, with voting rights. The idea of launching the Level 1 and 2 subcategories was to avoid one radical solution, of the all or nothing kind.

In its first months, however, the Novo Mercado seemed doomed to failure. The first listing in the segment was only in February 2002, when Companhia de Concessões Rodoviárias (CCR), a highway concession company, decided to go public. Its first days were marked by few trades and a drop in share prices. In April 2002, it was the turn of Sabesp, the water utility company of the state of São Paulo, to migrate from the traditional listing to Novo Mercado. No other company attempted to get listed in the segment that year. Talk about the Novo Mercado revolved around comments whose tone alternated between dismay and “we told you so”.

Despite the criticism and lack of concrete results, Bovespa was convinced that the self-regulation model grounded in selective rules was more than adequate. The segment remained limited to these first companies until May 2004, when Natura, the cosmetics company, went public, kicking off a new wave of IPOs in Brazil. That year; another four companies were listed in the segment, and since then, this number has been rising. By the end of April 2013, 178 primary and secondary share offerings had been undertaken in the segment.

Several of these companies migrated to the Novo Mercado in an attempt to improve their corporate images among investors. In the middle of corporate upheavals, companies like the Hering textiles company and roofing manufacturer Eternit saw a chance to reset their management restructuring by getting listed in the premium segment of the BM&FBovespa. In other cases, migration to the Novo Mercado was the way they found of increasing the value of their shares and using them as bargaining chips in merger and acquisition transactions. However, not all the companies listed on the Novo Mercado brought good tidings to their investors. There were also deceptions, caused by a variety of reasons. The IPO boom in the years prior to the international downturn — especially in 2007 — led several less well-prepared companies to go public in order to take advantage of the generous window of fund raising opportunities provided by the market. Years later, some of them revealed to having used the Novo Mercado merely as a check-list of steps to be followed, rather than as a foundation for governance principles to be actually incorporated into their organizations.

The most notorious case was the sugar and alcohol producer Cosan. In 2007, it announced a plan to list its parent company, Cosan Limited, based in the tax haven of the Bermudas, on the New York Stock Exchange (NYSE). In its IPO, it intended to offer two types of shares: ONA shares that gave one vote per share; and ONB, which carried ten times the voting power and would be in the exclusive domain of the controllers. Shareholders who invested in Cosan on the Novo Mercado, where the principle of “one share one vote” is valid for all investors, did not like the idea of having to convert their shares into Cosan Limited ONA shares. Stories like this have proven that the Novo Mercado cannot be regarded as a means to an end, but rather as seal of best practices whose commitment to better governance should be reaffirmed by companies on a daily basis.

Reforms

The Novo Mercado has undergone a number of small adjustments to its regulations over the years, but the most important reform to its rules took place in May 2011. In this period, the difficulties that the BM&FBovespa was to face in order to elevate the governance practices of its most sophisticated listing level became clear. To make any headway, each item of the reform had to be approved by at least two-thirds of the companies listed. Although relevant aspects have been well-accepted by companies, such as the veto on the accumulation of the positions of CEO and chairman and the mandatory opinion of the board of directors with regards to takeovers, others that are as or more important have not gained traction.

A hail of “no’s” has greeted the proposals of increases from 20% to 30% of the minimum proportion of independent board members on boards of directors; the obligatory existence of audit committees; and the mandatory offering to shareholders that reach 30% of the capital. Those who believed that the BM&FBovespa was beat, however, were mistaken. These matters continue to be discussed by the stock market, which is already planning a new reform.

Future

One of the challenges of the Novo Mercado for the coming years will be to attract relevant companies in the Brazilian capital market. Among the demands that keep large companies away is the adoption of the Market Arbitration Chamber (Câmara de Arbitragem do Mercado, CAM), created by BM&FBovespa in 2001 as a forum for corporate conflict resolution. Large companies are reluctant to adhere to the CAM without knowing how it tends to rule on such matters — the chamber has solved

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very few cases to date. Thus, big-name companies in the Brazilian stock market, such as mining giant Vale, tobacco company Souza Cruz and retail chains Lojas Americanas and Companhia Brasileira de Distribuição remain outside the Novo Mercado.

In other cases, regulatory obstacles hinder voluntary adhesion of companies. Companies in the civil aviation segment, for example, cannot have more than 20% of their voting capital in foreign hands, in accordance with the Brazilian Aeronautical Code. However, the government is considering increasing this limit to 49%, which could give the opportunity for companies in the segment, like Gol and TAM, to migrate to the Novo Mercado. As the companies in the segment can only issue shares with voting rights, restrictions of this type make getting listed in the Novo Mercado unfeasible. The banking sector, which involves large joint-stock institutions, also needs presidential authorization in order to increase the slice of voting capital in the hands of foreigners, which currently varies according to the institution. And Petrobras, the largest Brazilian company in terms of market capitalization, is also unable to join the Novo Mercado due to regulatory issues. According to the Oil Law of 1953, the capital of the oil company must be divided between preferred shares and common shares, and most of the voting shares must belong to the state.

Specialists and authorities in Brazil are unanimous in their position that the main challenge of the Novo Mercado will be staying up-to-date. It is essential that the rules evolve according to investor demands and interest on the part of companies to improve their practices. Nirvana for its creators would be when, at some moment, the Novo Mercado would cease to exist, because it would include all the companies trading on the stock market. But it would seem that this is increasingly a pipe dream.

The requirement for all shares to have voting rights is an extremely difficult principle for all companies to adopt. Besides regulatory restrictions, many of them want to preserve the figure of the controlling shareholder and opt for issuing preferred shares or the so-called "units", which bundle together common shares and preferred shares into a single package. Investors, in turn, agree with the attempt to preserve a controller in some cases — and, of course, they are partial to the higher dividends offered by the preferred shares. It seems that the liberty of companies and investors to design their agreements on a case-by-case basis will be preserved. It will be up to the Novo Mercado regulators, therefore, to keep it "new" over time, linking it to the demands of investors and companies without neglecting the essence of fair governance. This is its big challenge for the coming years.