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State Owned Enterprises and the upside down Activism

We are facing the rise of a twisted and upside down activism from the controlling shareholder of publicly listed SOEs, which has been weakening control mechanisms enforced in response to the last decade's shameful corruption events.

Recently in Petrobras, we witnessed Federal Government resorting to legal maneuvers and arbitrary decisions to elect board members that had already been ruled out according to the company's bylaws – supported by the SOE Law and the Brazilian Corporate Law. It has set a precedent that can be used in unimaginable circumstances from now onwards.

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The term 'activism' causes concerns in companies based in developed markets like the USA. In such countries, corporate disputes have become such a sophisticated industry that some stances supported by investors are seen as frivolous and opportunistic. As a backlash, companies have developed procedures to protect themselves from such initiatives.

Given the characteristics of the local market, this reality does not apply to Brazil. Investors usually prefer to dialog individually with their investees. They do not usually resort to group confrontation as their first option, with rare exceptions. At Amec, we have been using the expression Active Engagement (freely translated as a variant from "Active Ownership") to name the relationship between shareholders and the company's management.

Genuine activism, of course, remains essential in minority shareholders' toolbox, but it has increasingly been used as a last resort for when dialog fails. That's how the modern interpretation of a fund manager's fiduciary duty pictures responsible investment. Unfortunately, however, we are facing a new peculiarity in the corporate governance handbooks: an upside down activism from the controlling shareholder in State Owned Enterprises (SOEs) that has deliberately harmed such companies.

WHEN THE GOVERNMENT IS A SHAREHOLDER

The Brazilian Federal administration has been straying far from best governance practices for a while, leaving the impression that the rules enacted after the last decade's shameful events are no longer strictly enforced. Among the advances achieved in the decade, we highlight the very own SOE Law.

However, since early 2021, SOEs' internal governance bodies have been increasingly challenged by frequent changes in management – which have often failed to follow the standards set by the Securities and Exchange Commission of Brazil (CVM). Such events have sparked significant debates on the lack of autonomy of SOEs' management and board of directors.

One can assume the fundamental principle of the Brazilian Corporate Law is left aside in SOEs: shareholders and managers must make decisions on behalf of the company's best interests.

On a recent note, CVM used the word "weirdness" when referring to the actions of the Brazilian government as a controlling shareholder.

Amec Opinion



September 20, 2022

The market feels that the Federal administration still uses publicly listed SOEs as an extension of the cabinet, considering they carry nominations and replacements as arbitrarily as it happens in the government. This stance shows such companies have little autonomy. Moreover, as if such terrible examples weren't enough, they open precedents that could pave the way for new mistakes in private Brazilian companies.

Recent events on Petrobras back up those arguments. The company has had three CEOs in the past 12 months, and the Federal administration has changed its nominees to the board on several occasions during this period. This political voluntarism made investors wary of how the company was developing projects, leading to steep volatility in share price. In addition, members of the administration have publicly criticized the company's management on several occasions, signaling an undue interference in its corporate dynamic.

PRECEDENTS AND LEGAL MANEUVERS

Minority shareholders are quite familiar with the frictions caused by the election of board members. Roadblocks to name independent board members have been a tool to restrict rights for years, sparking a series of administrative procedures and emergency audiences with regulators. The new scenario holds the controlling shareholder as the one who suffered the blow instead of the minority shareholders.

Petrobras' governance bodies carried out an internal evaluation in the run-up to the latest Petrobras EGM on August 19, 2022. As a result, they ruled out two out of eight board nominees proposed by the Federal Government for failing to comply with requirements set by the SOE Law. We will not discuss the reasons behind the company's decision, which follows its bylaws, the SOE Law, the decree that regulated it, and the Brazilian Corporate Law.

Following a CVM request, Petrobras said the sovereignty of internal rules and the board should prevail. All the elements suggested the Federal government would have to propose other names, a reasonable decision that would have avoided unnecessary disputes. But the government publicly announced that it would insist on approving the rejected professionals, in a clear sign of animosity that devalues the procedures set by Petrobras' bylaws.

CVM did not prevent the government from nominating the vetoed professionals again on election day – a new ruling that apparently found support in its board! In this context, one may assume the independence of its remaining managers (executives and directors) is under threat and that considerable instability and legal insecurity will prevail in Brazilian AGMs.

Amec Opinion

September 20, 2022



Resorting to legal maneuvers and arbitrary decisions to elect board members who fail to comply with governance standards compromises investors' public evaluation. In this case, board members elected by such a crooked path were not subject to the scrutiny of proxy voting agencies or foreign or local investors who voted electronically.

It creates a harmful precedent that points out a violation of internal rules and institutional setbacks supported by the capital markets regulator, which could further harm the SOE Law. Moreover, such a path considerably increases market agents' risk perception, compromising private investment plans, significantly down valuing SOEs' market cap, and putting Brazil further away from OECD's capital markets regulation.

Considering SOEs have already been posting a positive financial performance, we can only think that the results could have been even better if it weren't for such arbitrary decisions. May the principles of transparency, equality between shareholders, corporate responsibility, and public accountability never be forgotten in this uncertain future that looms for corporate governance in this country, threatening our progress so far.

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