

Report *Dynamo* 24

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Fiscal Board (“Conselho Fiscal”)

Conselho. (Pg) from the Latin *consiliu*. 1. opinion, judgement. 2. Given warning, admonition. 3. Wisdom, prudence. (Translator’s Note: in Portuguese both *counsel* and *council* (with the meaning of board) are represented by the word *conselho*).

Fiscal. (Pg) from the Latin *fiscale*. 1. Person charged with the verification of certain acts or compliance with certain dispositions. (Translator’s Note: in Portuguese *fiscal* does not have a merely financial sense, also meaning an inspector or a controller).

The story (or is it history?) always begins at the General Shareholder’s Meeting. One should expect that the controlling shareholders would have previously decided on all matters and the results will be merely announced to the market in the Shareholder’s Meeting. Hence, since there are no surprises, the meetings become ever more monotonous and predictable. That is, until, without any prior notice (as allowed by the law), a minority shareholder requests the installment of a Fiscal Board, disturbing the order and creating havoc. There it is! Now lunch will have to be delayed, boredom ends, debates arise and, eventually, the meeting’s records, which had been previously prepared - for the sake of “speeding up the procedures” - will have to be rewritten.

A Fiscal Board? Come on! Why should the company, so frugal in its expenses, have to put up with this additional cost? Is there distrust concerning the company’s management? That is very serious and probably intolerable. Why didn’t the

minority shareholders talk to us first, instead of exercising their rights (with the petulance of those who believe to have such rights)? We thought there was a good relationship among all shareholders in this company and now this comes along! Secretary, please check all documentation brought by this minority shareholder, in order to verify the validity of his solicitation. It’s absurd! How rash! The controlling shareholder isn’t even ready to indicate his representatives! The chairman of the board addresses the minority shareholder: if there is any irregularity, it is best to discuss it among ourselves, instead of publicly exposing the company (which happens to be a public company, by the way!). And so it goes.

The paragraphs above describe, somewhat sarcastically, what we have experienced in a number of Shareholder’s Meetings in which the Fiscal Board (“FB”) subject was brought up. Thence, our idea of writing about the subject and why we consider it one of the most effective instruments at the disposal of active minority shareholders.

The economic and political literature discussing the theory of Agents and Principals is increasingly vast. This theory is about how a group of individuals (agents) establish mechanisms that allow them to follow and control their representatives (principals) in a given organization. Also, the concept that a public company should be monitored by all shareholders is universal. This is corroborated by the empirical evidence presented by the conseil de surveillance and the commissaires aux comptes in France and Belgium, as well as by their English and American counterparts, the board of directors and the FBs. Also, the German Aufsichtsrat and Abschlussprüfer and the Kontrollstelle from Switzerland represent similar principles.

According to Waldirio Bulgarelli (“Legal Regimen of FB’s” chapter III), the Brazilian model, which follows the international trends of modern corporate management, has four different spheres of influence within a company: the General Shareholder’s Meeting (the sovereign power); the Board of Directors (compliance, orientation and certain management decisions), the executive officers (management and representation) and the Fiscal Board (auditing of management actions and financial statements).

The FB is an indispensable part of this model. Nelson Eizirik (“Reform of Public Companies and of the Capital Markets”, page 107) wrote: “The presence of the FB is crucial, as it aims to convey to shareholders all information necessary to exercise their right to scrutinize a company’s management, and to vote with full knowledge of the facts at a Shareholder’s Meeting”.

It should also be noted that the FB is the only formal stage in which the minority shareholder with preferred shares is legally entitled to elect a representative.

The installment of a FB is usually requested by the minority shareholders, since the controlling shareholder generally trusts the management he picked to run the company, that is, when he doesn’t run it himself. Minority shareholders may request the installment of a FB at any Shareholder’s Meeting; actually they even have the right to request the company to call a Meeting with the sole purpose of installing a FB. And, if the company does not do as requested, the shareholders may call the Meeting themselves on behalf of the company. In order to do so, these shareholders must represent 10% of common shares or 5% of preferred shares.

One of the actions that Dynamo has been systematically pursuing is the gathering of enough shareholders’ votes so as to

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guarantee of FB's in companies our funds have invested in.

Preferred shareholders have the right to elect one representative to the FB. Likewise, minority-voting shareholders also have the same right. The controlling shareholder has the right to as many seats as necessary to maintain the majority in the FB. In other words, if minority voting and non-voting shareholders each elect one member, the controlling shareholder will have the right to elect 3 members. We will not discuss the literature concerning the pitiful possibility of fraud by controlling shareholders that form fake minority blocks of shares thus preventing true minority shareholders of exercising their rights (on that subject, see Modesto Carvalhosa, "Comments on Corporate Law; vol.5, pg.234).

We would rather discuss the concept of a FB, whose responsibilities are to carefully examine financial statements and to scrutinize management's actions, but since the majority of members are elected by the controlling shareholder, is it not a case where one is auditing oneself? This conflict apparently derives from an exceedingly cautious behavior by the legislator in relation to the effective influence exerted by minority shareholders in the FB. With that in mind, Dynamo has been studying the idea of proposing to some companies that they voluntarily adopt rules that allow for majority representation of minority shareholders in the FB. This suggestion is particularly suited to those companies with high quality and transparent accounting and trustworthy management. In this case, given the operating and ethical standards of the company, the higher level of comfort to investors resulting from this structure should bring considerable benefits with no costs.

The core competency of the FB is very broad. However, as far as minority shareholders are concerned, some of these mandates are of particular interest.

1. At least one of the members of the FB shall attend the General Shareholders' Meetings and answer the requests for information made by any stockholder concerning acts of the executive directors and compliance with their legal and statutory duties, the annual report, proposals to be submitted to the Meeting

and financial statements. It is a good opportunity to clear up points of doubt concerning either an accounting issue or the strategy the company provided the shareholder prepares correctly for the Meeting. A greater level of scrutiny on the part of shareholders makes the work of the FB more dynamic and productive as the responsibility of the members of the FB for any omission in their duties is joint and several. However, it must be noted that a dissident member that registers his vote and informs the directors of the company is exempt from any effects of the referred vote. The dissidence of the representatives of the minorities in the FB is a valuable information for the market concerning the quality of the management of any company.

2. The board of directors is required to place at the disposal of the exercising members of the FB (within ten days) copies of the minutes of their meetings. This can be very important to review any decision approved by the Board of Directors or by the executive officers. Of special interest are the decisions that involve conflicts of interest with the controlling shareholder, such as, for example, the sale or acquisition of assets from related parties, credits to related parties, investment plans and capital structure issues. In addition to these specific demands, any member of the FB may request executives of the company to explain any issue or even to produce special managerial reports to help him perform his duties.

3. Also at any time, shareholders that represent at least five percent of total capital may require of the FB further explanations concerning matters within its attributions. This is one of the faculties of the law that needs to be more appreciated by minority shareholders. In cases when executives are not particularly transparent about company issues, this is an effective way to prepare for Shareholders' Meeting as well as for supporting corporate governance practices. In addition, the fact that shareholders must form a block of 5 percent as required by law, as we always seek to do at Dyna-

mo, is in itself a positive collective action for the company, as it certainly results in a better comprehension of management actions by the market.

4. Finally, in order to clarify any issue that members of the FB judge necessary to perform their duties, the FB may request the company to appoint three professionals, from which the FB will pick one, to issue an expert opinion. In this case, the fees of this expert are paid by the company. This item could be extremely important, if it had not been so conservatively drawn up in the Law. This is so because the controlling shareholder actually elects the majority of the FB so he can easily block this measure by (a) making the FB collectively determine that the expert's services are not necessary; (b) indicating the three experts (by indicating the directors of the company, that in turn must draw up the list of three experts and submit it to the FB) and, finally, (c) making the FB choose the "right" expert.

Noting the attributions and purposes of the FB and, through them, the possibilities for the minority shareholders to exercise governance, one understands why there is an obvious concern within our corporate law with the qualification and remuneration of the board members.

In the first place, the law was drafted so as to prevent what legal experts call the participation *ad terrorem* or the abuse of rights, where the board member seeks to obtain benefits for himself and not for the company. The FB member that uses this blackmail strategy is a predator of the FB's reputation, which is the reason why they must be rapidly exterminated. It should be noted that the corporate law determines specifically (clause 154) that all directors (including the FB members) shall exercise the attributions conferred to them by law (or by the by-laws) to meet the goals and interests of the company. If there is a conflict of interests between the company and the group of shareholders who elected him, it is the duty of member of the boards to defend the interests of the company, even if his actions harm the interests of those who elected them.

Secondly, and maybe in a more subtle manner, the law seeks to emphasize the

responsibility of shareholders when they choose their representatives in the FB. This choice cannot be based upon the desire to reciprocate to the person indicated or by the recognition of the services that he eventually performed, however outstandingly, but in other areas. To the contrary, they should focus only on the specific competence of their representatives to deal with the questions pertinent to the FB.

We believe that a greater professionalism and a more active posture on the part of the FB in publicly traded companies in Brazil can help to reduce the hiatus between non-compliance of the law and punishment that exists in this country. For Dynamo, the FB is becoming an instrument of increasing importance in the activity of governance. When they work well, a good company benefits from the FB as it provides

an additional guarantee for the quality of the management and of the information available to shareholders. All this brings obvious results to the image of the company in the market, benefits that are transferred to the price and liquidity of its stock, reducing its capital costs.

Dynamo Cougar x Ibovespa x FGV-100 (in US\$ dollars - commercial selling rate)

Period	DYNAMO COUGAR*			FGV-100**			IBOVESPA***		
	Quarter	Year to Date	Since 09/19/94	Quarter	Year to Date	Since 09/19/94	Quarter	Year to Date	Since 09/19/94
1993	-	38,78	38,78	-	9,07	9,07	-	11,12	11,12
1994	-	245,55	379,54	-	165,25	189,30	-	58,59	76,22
1995	-	-3,62	362,20	-	-35,06	87,87	-	-13,48	52,47
1996	-	53,56	609,75	-	6,62	100,30	-	53,19	133,57
1997	-	-6,20	565,50	-	-4,10	92,00	-	34,40	213,80
1 st Quar/98	16,55	16,55	675,66	18,15	18,15	126,83	15,07	15,07	261,14
2 nd Quar/98	-8,70	6,40	608,30	-19,40	-4,80	82,80	-19,60	-7,50	190,30
3 rd Quar/98	-33,50	-29,20	371,20	-27,20	-30,70	33,10	-33,40	-38,40	93,50
4 th Quar/98	14,20	-19,10	438,10	-1,20	-31,50	31,50	-0,10	-38,40	93,30
1 st Quar/99	6,81	6,81	474,80	11,91	11,91	47,20	12,47	12,47	117,36
2 nd Quar/99	24,28	32,75	614,36	24,60	39,44	83,41	2,02	14,74	121,76
3 rd Quar/99	3,17	36,96	637,01	-4,71	32,87	74,77	-7,41	6,24	105,34

(*) The Dynamo Cougar Fund figures are audited by KPMG and returns net of all costs and fees, except for Adjustment of Performance Fee, if due.

(**) Index that includes 100 companies, but excludes banks and state-owned companies. (***) Ibovespa average.

For any further information,
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