Report
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De-Listings: Markets, Monopolies and Regulation

The liquidity of a stock is given by the number of buyers and sellers that place their bids and offers in the market on a daily basis. One of the best characteristics of liquid stocks is that they trade closer to their fair value. Any distortion, as perceived by the agents, is quickly adjusted. This is what happens in the American markets where a significant number of public companies have dispersed control, and there is a well established culture of investing in stocks.

In Brazil, with respect to liquidity, we have two serious problems: on the demand side, high interest rates have always pushed investors away from equities; and on the supply side, the concentrated control profile of our public companies. It is precisely with this last factor in mind, and its effects on liquidity in key moments of a publicly-traded company, that one should strive to understand the reasons for the regulations recently enacted by the CVM on tender offers and de-listing processes in the Brazilian market.

Among the main difficulties for markets to function efficiently, as noted in all relevant literature, is the existence of monopolies (or monopsonies) and oligopolies (or oligopsonies). In such cases, the prices derived from the mechanisms of demand and supply are socially inefficient and only government intervention can adjust such anomaly.

In our view, the power of a monopoly is present in any de-listing process as the controlling shareholder is, de facto, the only buyer for the existing non-controlling shares. Moreover, because of his proximity with the management, he can interfere in the performance of the company, and by doing that, he acquires a substantial competitive advantage in defining the best timing for initiating the process. It is for no other reason that the CVM, in its role of regulatory agency in charge of the Brazilian capital markets and with the powers granted to it by Law 6385 of December 1976, has established specific rules for such situations. The most recent versions of the various Instructions published by CVM on the subject are Instruction 229 of January 1995 and Instruction 299 of February 1999, both of which were very recently modified by Instruction 345 of September 2000. We believe that all three deserve a closer analysis.

With respect to the specific issue that we are analyzing, Instruction 229 requires that: (i) the de-listing process has to be approved in a Extraordinary Shareholders' Meeting ("ESM") by the majority of all shareholders (including the non-voting preferred shares); (ii) the tender offer for de-listing has to be accepted by 66.7% of the shareholders that manifested their opinion in the process; (iii) even if the de-listing is approved, the non-accepting shareholders may sell their shares up until six months after the ESM that approved the accounts for the first fiscal year after the registration as a public company was cancelled.

Why are those rules important ? First, the de-listing has to be approved by the majority of all shareholders, which means that in companies where the controlling shareholder has less than 50% of total capital (or, in other words, is more leveraged), this decision cannot be taken unilaterally. This is particularly relevant in cases where the controlling shareholder artificially creates a negative scenario to stimulate minority shareholders to accept the tender offer. Evidently, if the controlling shareholder is less leveraged, i.e., has more than 50% of total capital, this instance is not effective as a way to regulate the de-listing process.

Even when ESM approves the de-listing process, the controlling shareholder has to tender for all remaining shares at a given price, for which there is no specific rule. The de-listing will only proceed if a super-majority of 66.7% of the shareholders that manifest an opinion accept the offer. Therefore, if a shareholder believes that the offer price is not fair, he should expressly register his negative response, as shareholders that do not manifest a position are counted out of the 66.7% requirement. As a result, if more than 33.3% of the shareholders vote against accepting the tender price, it becomes evident that the price is too low. A shareholder that opposes the de-listing would have a complicated problem if more than two thirds elect to sell as he would be left at the mercy of controlling shareholder and his illiquid shares would probably be worth even less than the tender price. That is precisely the reason why it is so important that the offer for acquiring the shares remain valid for a sufficiently long period.

Summing up, the objective of Instruction 229 is to prevent, to the extent possible, that the monopolistic position of the controlling shareholder allows him a "opportunistic" decision to de-list his company when it most suits him. In addition, it also prevents him from squeezing the minority shareholders with a liquidity trap.

With all of its imperfections – there is no such a thing as a perfect regulation, only possible regulation – Instruction 229 worked efficiently. Actually, so efficiently that a questionable search for legal loopholes for bypassing the 229 began right after its implementation. And the result of this search was what became known in the market as

- for lack of better translation - a "white de-listing", meaning that, for all practical purposes, the company becomes private although it keeps its registration as a public company.

Instead of going through all the stages of Instruction 229, in particular the ESM and the issue of the approval by 66.7%, the controlling shareholder quickly concluded that he could do better by simply making a voluntary public tender offer for all remaining shares, without having to deal directly with the question of a subsequent de-listing. Whereas it is true each shareholder would have a theoretical option whether to accept the tender or not, this is where the monopolistic nature of the situation becomes pervasive. The decision by each shareholder is influenced by the decision of all others because if the price is too low and there is a general perception that very few will accept the offer, there is a big incentive not to sell. However, if there is a general perception that everyone will sell (which is almost always the case), the possibility of being left with a completely illiquid stock makes the sale inevitable. In a public voluntary tender offer, it is difficult, a priori, to assess the final results and the problem becomes especially relevant as, different from the rules of Instruction 229, the offer does not have to remain open for any period after the event. Some controlling shareholders even tried two-tier tender offers (with higher prices for the first sellers) as one more form of squeezing out the other shareholders but such practice did not prosper. In the cases where Dynamo was involved and we felt that the offer price was too low considering the company long term fundamentals (which has not always been the case), we tried to argue technically with the company but usually received the ironic answer: "if you think the price is too low, just don't sell it; we welcome truly *long term* investors...". That is exactly the point: any shareholder that chooses not to sell in the tender offer is running a substantial risk of becoming long term investor against his will as the public market for his shares will disappear. The use of the liquidity trap, made possible by the monopolistic nature of the controlling shareholder as the only buyer, was, until recently, the main rationale behind the trick of circumnavigating Instruction 229.

As should be expected, the frequency of cases where minority shareholders were obviously abused increased and the CVM had to act by issuing Instruction 299 in February, 1999. In addition to dealing with issues related to disclosure, as far as the theme of this Report is concerned, Instruction 299 established that: (i) if more than one third of minority shareholders accept the offer, the company is required to extend its offer for 15 days; and (ii) the controlling shareholder is required to disclose whether he intends to subsequently de-list the company or not, and if he does not, he will only be able to de-list the company two years after the 299 offer.

The objective of (ii) is to distinguish between a legitimate tender offer and one done with the sole, albeit hidden, purpose of de-listing the company. The objective of (i) is to reduce the effectiveness of the liquidity trap (we must say that the wording of Instruction 299 is sometimes imprecise and we have not seen any case recently where this 15-day extension was actually granted). We have two worthwhile comments: first, this 15-day extension is too short to offset the liquidity trap (especially if compared with the 6-month period required by Instruction 229 for another purpose but with the same final result) as during such period, minority shareholders still will not know whether the tender offer will be widely accepted. Second, the declaration by the controlling shareholder that he will not de-list the company is not enough to reverse the impression that an offer that may encompass the entire free float is anything but an attempt to obtain the practical effects of Instruction 229 without being submitted to its restrictions. The truth is that when a controlling shareholder is willing to buy back a substantial part of the free float, reducing liquidity considerably, it seems obvious that he is not exactly working to develop the market for his companies' shares, but rather to eliminate it. The interrelation between Instructions 229 and 299 became so evident in the cases before and after the implementation of 299 (we commented on some of them in earlier editions of this Report) that CVM was left with no choice but to issue a new Instruction clearly defining what is a considered an effective offer for de-listing and what is (and under which conditions it must be structured) a legitimate offer from a controlling shareholder to acquire more shares of his company. This is the scope of Instruction 345 of September 2000.

In addition to some important adjustments on Instruction 229, the new instruction distinguished very clearly what is a controlling shareholder eventually acquiring shares in the market and what is an effective de-listing process. The application of Instruction 299 is now limited to the cases when the controlling shareholder is willing to acquire less than one third of the free float during the period of two years. Offers encompassing more than such limit will have to follow the rules of Instruction 229, as it constitutes, in the opinion of the regulator (with which we agree entirely), a de-listing. As a consequence, faced with the decision by the controlling shareholder to acquire shares in his company, minority shareholders will know in due time whether such offer represents a simple attempt to increase his stake (through 299) – which may actually be a good sign inasmuch as an insider believes the shares to be cheap – or a broader strategy to de-list the company, in which case the dangers of the liquidity trap are, to a large extent, mitigated by the rules of Instruction 229.

De-listing a company is a legitimate right of the controlling shareholder, and its exercise under fair conditions adds rationality to the market as it does not make any sense to keep a company public against the will of its controlling shareholder. However, there are elements that create distortions in the market during such processes and they must be identified and corrected. Monopolies are usually structural. For them to work under socially efficient conditions in capitalist economies, they must be regulated. If the monopoly derived from a controlling shareholder buying back all shares of his own company is not properly regulated, markets will become less efficient, as we have seen recently in Brazil. That is why we believe the evolution of the regulatory environment described in this report is highly positive. Anyone who thinks that the current rules are still imperfect, has an opportunity, if not an obligation, to contribute to its improvement by submitting his suggestions to the proper authorities. On the other side, the ones that limit their critics to falsely liberal arguments linked to free markets are either uninformed about the institutional construction of markets in developed economies or, more likely, yearning to maintain anachronic benefits.

In fact, this recent production of regulation on de-listing is a result of what we believe to be a distorted bias of the Brazilian corporate law. This law was conceived as an instrument for the development of the capital markets in Brazil. As such, it concentrates more on issues related to the expansion of markets than it does on its contraction, as has more often been the case recently in Brazil. When the controlling shareholder is willing to sell shares to the public, he has all the right incentives to provide investors with the best level of information in order to achieve the best valuation. Even so, if his perception on the future of the company do not coincide with the investors', there will not be a deal, that is, the final decision belongs to the market. The problem is the opposite case when the controlling shareholder wants to buy back the shares and tries to convince investors that his company is actually not worth as much as everyone believed. In this instance, interests become so conflicting and the financial amounts can be so significant that even the new instructions enacted by the CVM have not hindered the creativity of the relevant agents in their search for new alternatives to bypass the restrictions of 229/299/345. It is for no other reason that we are following closely the development of the recently announced incorporation of BR Distribuidora by its parent company, Petrobras. If it goes through under the structure originally proposed, it may represent a return to the old and unfair habits that prevailed before Instruction 345.

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
1stQuar/98	16,55	16,55	675,66	18,15	18,15	126,83	15,07	15,07	261,14
2ndQuar/98	-8,70	6,40	608,30	-19,40	-4,80	82,80	-19,60	-7,50	190,30
3rdQuar/98	-33,50	-29,20	371,20	-27,20	-30,70	33,10	-33,40	-38,40	93,50
4thQuar/98	14,20	-19,10	438,10	-1,20	-31,50	31,50	-0,10	-38,40	93,30
1stQuar/99	6,81	6,81	474,80	11,91	11,91	47,20	12,47	12,47	117,36
2ndQuar/99	24,28	32,75	614,36	24,60	39,44	83,41	2,02	14,74	121,76
3rdQuar/99	3,17	36,96	637,01	-4,71	32,87	74,77	-7,41	6,24	105,34
4thQuar/99	49,42	104,64	1001,24	62,92	116,46	184,73	59,53	69,49	227,58
1stQuar/00	6,15	6,15	1068,96	11,53	11,53	217,56	7,08	7,08	250,77
2ndQuar/00	-2,43	3,57	1040,57	-6,26	4,55	197,67	-9,03	-2,59	219,10
3rdQuar/00	4,68	8,42	1093,99	0,88	5,47	200,31	-6,10	-8,53	199,63

(*) 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.

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