Foreign Direct Investment in Brazil from 2006 to 2008: Economic and Juridical analysis of American Depositary Receipts in the Brazilian Market

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Abstract: This paper studies the impact of American Depositary Receipts on the growth aspect of the Brazilian market and attempts to measure the market’s ability to foster the formation of new enterprises and encourage Brazil economic expansion. The hypothesis of this paper examines whether investment allocation decisions of mutual fund managers have helped or hindered the development of the local stock market in Brazil. For this study, it is necessary to investigate two research subjects: (i) the set of Brazilian macroeconomic policies performance, (ii) and exploration of the juridical structure of American Depositary Receipts. Research methodologies are theoretical literature review and secondary data based on Brazil and United States official websites.

1. Introduction

Technological developments are reflected sharply in all aspects of today's world. Their impact is extraordinary in the fields of economics, finance activities and trade. This paper studies one of the technological securities: the American Depositary Receipts - ADRs – special on the aspect of growth of the developing market in Brazil from 2006 to 2008, due to its importance of understanding economic history to improve the use of ADRs in Brazil.

According to the Organization for Economic Cooperation and Development – OECD, Brazil has been reducing growth economics performance annually. By contrast, the country has improved in the areas of providing and setting policy, seeking to resolve problems and identifying good practices, as provided, for example, by the Transparency Portal – a government accountability site that aims at increasing fiscal transparency of the Brazilian Federal Government – particularly from 2006 to 2008.

This helps social development and environmental protection as a whole. Brazil’s government is at the forefront of efforts to understand, and to respond with new developments and concerns. These include trade and online security, and the challenges related to reducing poverty in the developing world and improvement during the next years and helps to ensure economic growth through ADRs.

Presently, financial transactions require electronic data interchange documents. The economic actors, particularly enterprises and governments, seek technological
innovation professionals with a view to improve their efficiency and to reduce operating costs, particularly in international context. The general aim of the study is to attempt to measure the market’s ability to foster the formation of new enterprises and encourage Brazil economic expansion.

More specifically, this study analyzes the use and performance of a set of Brazilian macroeconomic policies and an exploration of the American Depositary Receipts structure to understand the investment on the Brazilian market.

The research methodologies are theoretical and literature review with secondary data based on Brazil and United States official websites.

2. Brazilian Macroeconomic Challenges in the Contemporary Era – Historical Panoramic

First, on this study, the term “the Contemporary Era” is represents the time between 1990 and 2008. It is necessary to understand because the study presents the panoramic of Brazil economic historical in three areas: the numbers of Brazilian public finance policy, the brief history of Brazilian regulatory and fiscal policy.

On the end of 20th Century, Brazilian infrastructure and service enterprises such as telecommunications, utilities, airlines and petrochemicals are among those initially targeted for privatization (ARIDA, BACHA and LARA-REZENDE, 2004, p. 89).

On that time, an improving business climate is providing further impetus for private investment (ARIDA, BACHA and LARA-REZENDE, 2004, p. 89). Net exports will continue to contribute positively to growth, in addition to keeping the external current account in surplus. The gradual reduction in trade restrictions throughout the 1990s has made foreign trade more responsive to external price signals and changes in relative prices (ARIDA, BACHA and LARA-REZENDE, 2004, p. 90). Continued effort to further remove trade restrictions is therefore welcome. It is also important to note that export growth remains constrained in key markets by tariff and non-tariff barriers, particularly in agriculture (ARIDA, BACHA and LARA-REZENDE, 2004, p. 90).

The improvement in the economic and law outlook owes much to the strengthening of institutions after 1996. Of particular importance are the inflation targeting framework of monetary policymaking and Fiscal Responsibility Legislation.

These have become the main institutional pillars for macroeconomic in Brazil until today.

2.1 The numbers of Brazilian Public Finance Policy

The Brazilian authorities, anchored by a prudent monetary-fiscal policy of continued disinflation and a steady reduction in public indebtedness, allows the consolidation of
The primary surplus in 2006 was higher than both January (R$ 3.07 billion) and February (R$ 4.05 billion) of 2005, accumulating a positive balance of R$ 7.8 billion in the first two months of the year. The accumulated result over the 12-month period ended in February was R$ 85.9 billion, or 4.38% of GDP, slightly above the 4.25% target for 2012. Public sector borrowing requirements were R$ 8.62 billion below the nominal concept, after reaching R$ 14.86 billion a month earlier. The nominal deficit was financed by an R$ 8 billion increase in public securities debt, a R$ 6.8 billion increase in banking debt, and a R$ 1.4 billion hike from other sources as well as a R$ 7.6 billion reduction in external financing. The nominal deficit hit R$ 23.48 billion annually and R$ 78.55 billion over 12 months, or 4.01% of GDP.\textsuperscript{12}

The Brazil Central Bank Circular n. 2.727, of November 14\textsuperscript{th}, 1996, establishes the Special System for Settlement and Custody for entry government securities issued by the government and interbank deposits whose trustees are commercial banks and savings Banks.\textsuperscript{13} The Federal Treasury continued to substitute paper pegged to the Special System for Settlement and Custody rate for unindexed securities and other paper pegged to inflation.\textsuperscript{14}

2.2 A Brief History of Brazilian Regulatory Policy

After 1996, the rationalization of current public expenditure would free budgetary resources which could be channeled to finance higher, externality-rich public investment. At the same time, the reduction in indebtedness, as discussed above, should help reduce the crowding out of private investment (MESQUITA NETO, 2006, p. 25).

In 2006, the legislation on public-private partnerships, which have been confined predominantly to leasing operations and concessions, will complement the current legal framework for public procurement, thereby encouraging private investment, particularly in infrastructure market (MESQUITA NETO, 2006, p. 27).

An important policy objective is therefore to standardize requirements for the accounting and reporting of public-private partnerships operations, as well as the dissemination of information to markets and society at large, together with the risk assessment of individual projects (MESQUITA NETO, 2006, p. 27).

2.3 A Brief History of Brazilian Fiscal Policy

In 1990, Brazilian high public indebtedness remained an important source of vulnerability on the fiscal side. Against that backdrop, a reasonable medium-term objective would be to bring the public sector borrowing requirement into balance in the business cycle, underpinned by robust primary surpluses resulting in a sustainable decline in real interest rates (ESLAVA, 2006, p. 73).
From 1998, the fiscal adjustment has been contemporaneous with the increase in primary expenditure, thus being achieved in recent years primarily by hiking revenue and compressing public investment (ESLAVA, 2006, p. 73).

Non-mandatory spending commitments have at times been curbed through the ad hoc sequestration of funds during the fiscal year, making budget execution more difficult, in part by accommodating higher-than-expected increases in entitlements (ESLAVA, 2006, p. 74). This is because the retrenchment of current spending has become increasingly difficult, owing predominantly to downward rigidities in the budget. Revenue earmarking is widespread and minimum expenditure levels have been introduced over the years, often through constitutional provisions, severely curtailing budget flexibility (ESLAVA, 2006, p. 75).

The Fiscal Responsibility Law also provides for more transparent fiscal reporting. Budgets are to be presented in bi-monthly budget execution reports, as well as more comprehensive four-month reports in compliance with the LRF, including corrective measures if relevant provisions are breached (ESLAVA, 2006, p. 76).

Among other provisions from 2000, the Fiscal Crimes Law provides for detention of up to four years for public officials who:

- Engage in credit operations without prior legislative authorization (or in breach of credit or indebtedness ceilings);  
- incur expenditure commitments in the last two quarters of their term in office that cannot be paid within the current fiscal year, or without adequate cash balances;  
- incur unauthorized expenditure commitments;  
- extend loan guarantees without equal or higher-value collateral;  
- increase personnel expenditures in the 180 days prior to the end of their term in office; and  
- issue unauthorized unregistered public debt (ESLAVA, 2006, p. 76).


By introducing more stringent requirements on fiscal targets in the preparation of the Budget Guidelines Law, the Fiscal Responsibility Law strengthens its role in budget preparation and fiscal management in general:

- The Fiscal Targets Annex contains the assessment of compliance with the fiscal targets of the previous years, and the analysis of the net worth of the public enterprises, with emphasis on the use of resources from privatizations and asset sales in general. This is to avoid the use of capital revenues to finance
current spending and the inclusion of these revenues above the
line to generate higher primary balances; and
- the Fiscal Risks Annex contains a detailed assessment of
  the government’s contingent liabilities, including an evaluation of
  the likelihood of adverse outcomes in legal disputes. In the case of
  the central government, the Fiscal Risks Annex provides a detailed
  assessment of the impact of revenues on changes in the
  macroeconomic framework, as well as deviations from the
  macroeconomic parameters based on which the Budget Guidelines
  Law is formulated (ESLAVA, 2006, p.75-76).

3. A Brief History of American Depositary Receipts

American Depositary Receipts - ADRs - were first introduced in 1927 and are
negotiable U.S. securities representing ownership of publicly traded shares in non-U.S.
corporations (GANDE, 1987, p. 67).

GANDE explains the ADRs are quoted and traded in U.S. dollars on a U.S. exchange.
The dividends, if any, are also paid to ADR holders in U.S. dollars. ADRs were
specifically designed to facilitate the purchase, holding and sale of securities of non-

On XXI Century, entitles the current moment in which Brazil live as an informational
society like CASTELLS explains, since Eights, the revolution in information
technology became the core of the restructuring of the capitalist system itself, because
its logic and interests had a great influence on that development, although constituting
distinct processes, explaining further that “it is essential to understand the social
dynamics, maintain analytical distance and empirical interrelation between modes of
production.” (2000, p. 33)

In 2006, U.S. investors allocated eleven to twelve percent of their total equity portfolios
to non-U.S. equities. Some U.S. investors are interested in investing in Brazil
particularly for the large interest in the trading of ADRs. ADRs are an electronic
security and ADR programs are set up by U.S. Depositary Banks.^[1]

3.1 Brief of American Depositary Receipts juridical structure

Until now, even ARD is an electronic security, the structure of ADRs typically involves a
depository bank that acquires the domestic shares in the local market (either directly
from the company or in the local stock market) and deposits these shares with a
custodian bank (GANDE, 1987, p. 80).

Against these immobilized local shares, the depositary bank issues depositary electronic
certificates for sale in the U.S. All ADRs are structured with a specific “bundling ratio”
which denotes the number of underlying shares represented by each ADR (GANDE,
1987, p. 80).
3.2 Who’s who in American Depositary Receipts

- US INVESTOR contacts BROKER to buy ADRs;
- BROKER contacts a local broker in HOME MARKET;
- LOCAL BROKER purchases issuer’s shares in the HOME MARKET;
- LOCAL BROKER deposits underlying shares with the CUSTODIAN;
- CUSTODIAN instructs DEPOSITARY to issue ADRs;
- DEPOSITARY issues ADRs and delivers to investor BROKER; and
- BROKER credits investor’s account with ADRs and debits for cash (GANDE, 1987, p. 78-79).

3.3 American Depositary Receipts Levels

In 1990, the Rule 144A of Depositary Receipts – DRs - adopted to increase the liquidity of privately placed securities by allowing Qualified Institutional Buyers – QIBs - to privately resell these securities to other QIBs without a holding requirement or other formalities.

Consequently, ADRs can be issued at four different levels like MILLER explain:

- **Level I:** ADRs do not involve raising capital, are not offered to the public at large, and are not listed on an exchange, but instead, trade over the counter (traded over the counter and involving minimal Securities and Exchange Commission - SEC - registration);
- **Level II:** ADRs do not involve raising capital and are issued in a public offering. They trade on an exchange such as the New York Stock Exchange - NYSE -, the American Stock Exchange - AMEX - and the National Association of Securities Dealers Automated Quotation System – NASDAQ (traded over the counter and involving Securities and Exchange Commission - SEC - registration) and the issuer is subject to U.S. disclosure requirements (in each case not in connection with a U.S. public offering);
- **Level III:** ADRs are issued in a public offering in the same way that Level II and new capital is raised. The issuer must register with the SEC and is also subject to disclosure requirements (quoted or listed following a U.S. public offering and subject to the same Securities Exchange Act of 1934 periodic reporting requirements as Level II ADRs);
- **Level IV:** ADRs are issued under Rule 144A/Reg. S and are a hybrid of a public offering in the same way that Level II and a private placement and new capital is raised. Initially these issues
can trade only among Qualified Institutional Buyers – QIBs - that have a net worth of $100 million and have registered broker-dealer accounts. These securities allow foreign issuers to include a U.S. tranche without all the disclosure requirements and traded over the counter and involving Securities and Exchange Commission - SEC - registration (1999, p. 45-46).

3.4 Special Aspect of American Depositary Receipts - The Voting

Voting is a public manifestation of the investor and requirements applicable to foreign issuers are regulated, in the first instance, by local laws, like Brazilian law, which often are inconsistent with U.S. practices.

As reporting companies under the Exchange Act, Level II and Level III issuers are subject to a number of the requirements of the U.S. securities laws, including many of the corporate governance reforms mandated by the Sarbanes-Oxley Act of 2002[7] (REZAEE and JAIN, 2003, w/p.).

Although the SEC issued a concept release in 1991 asking for comments on whether depositaries should be required to facilitate ADR voting, the SEC has not mandated any such ADR voting measures. [8] While Level II and Level III issuers also must comply with applicable stock market and stock exchange listing requirements, the NYSE and NASDAQ regularly acquiesce to local rules and customs. [9] Therefore, in practice, ADR voting is mostly a matter of contract between the issuer and the depositary under the deposit agreement. [10]

From 2006 to 2008, large institutional holders of ADRs and market observers have begun to question existing ADR voting practices - both in terms of the procedural restraints and substantive rights. [11] Given the historically low voting patterns of ADR holders (in part a result of the inability of brokers to exercise discretionary voting), some issuers need the ability to count ADR votes for quorum purposes - perhaps the origins of the proxy itself. [12]

In February 2004, the International Corporate Governance Network (ICGN) published its "Principles for a Model Depositary Agreement." [13] The principles specify that ADR holders should receive complete voting materials not less than 21 days prior to any shareholder meeting, and issuers and depositaries should provide clear instructions to ADR holders on voting deadlines and procedures. [14] It also includes the procedural requirements for ADR holders to submit shareholder proposals or attend shareholder meetings. [15]

4. Brazilian Regulation of the American Depositary Receipts of Brazilian Enterprises from 2006 to 2008

In the 21st Century, the Brazilian Securities Commission – Comissão de Valores Mobiliários – CVM – [16], provided the ADR Ruling issue of not less than 15 days advance notice of shareholder meetings.
In 2002, CVM advised all Brazilian issuers to provide not less than 30 days advance notice of shareholder meetings, and all Brazilian issuers of ADRs representing common shares or preferred shares with voting rights to provide not less than 40 days advance notice.\[17\]

In 2006, according to the CVM, the recommendation for companies with depositary receipt programs aims to allow a greater participation of ADR holders in general meetings, taking into account the operational difficulties inherent in the exercise of voting rights by such shareholders.\[14\]

In the meantime, issuers and depositaries may want to consider the benefits of electronic delivery of voting materials. Progress toward that goal can be promoted by publication of voting materials and proxy forms on their websites, according to the CVM.\[13\]

On 21st Century, the Bovespa’s Corporate Governance organizer on Brazil the Level 1, Level 2 and New Market.\[18\] Level 1 listing requirements represent the most lenient set of listing requirements among the three-tiered scheme of the Novo Mercado (New Market). Bovespa’s cited goal for Level 1 companies is “to improve methods of disclosure to the market and to disperse their shares among the largest number of shareholders possible.”\[19\] And Level 2 represents the middle ground between the relatively lax listing requirements of Level 1 and the strictest level of corporate governance listing requirements of the Novo Mercado. According to the Bovespa website for Level 2, “[t]o be classified as a Level 2 company, in addition to the obligations of Level 1, the company and its controlling shareholders must adopt and observe a much broader range of corporate governance practices and minority shareholder rights.”\[20\]

Beginning in 2006, the Level 1 Bovespa Index (IBrX-100) fell by 2.8%; the Level 2 Bovespa Index (IVBX-2) by 1.8%; the Telecommunications Sector Index (ITEL) by 7.7%; the Electric Power Index (IEE) by 3.4%; the Special Tag Along Stock Index (ITAG) by 2.9%; and the Corporate Sustainability Index (ISE), by 5.4%.\[21\]

In 2007, depositary banks were already making strides to provide education to foreign issuers on the proxy process, and they had made a genuine effort to communicate information on their Web sites about their ADR programs, including shareholder meetings, according to the CVM.\[22\] Although not included in the ICGN principles, for an added degree of transparency, issuers and depositaries might consider publishing voting statistics (i.e., percentage of ADR voted, information on any shares voted by proxy, etc.).\[23\]

In 2008, according to the CVM, the ADR holders will be afforded all of the rights of ordinary holders (such as the right to vote on matters, attend meetings and vote shares directly)—many issuers may have the ability to make this change of their own accord while others are constrained by local laws.\[24\] But it is difficult to argue that ADR
holders as a matter of principle should not be entitled to at least the same rights as holders of the underlying shares represented by ADRs. \(^{[27]}\)

However, due to the increase in interest rates in the U.S. and in other developed countries that may reduce international investors’ enthusiasm for emerging market securities, the deepening of the domestic political crisis and the rise in the exchange rate \(^{[28]}\) brought instability to the market that presented volatile behavior and a negative result vis-à-vis the previous month (GONÇALVES, HOLLAND and SPACOV, 2005, w/p.).

5. Conclusion

American Depositary Receipt is one of the electronic document capable of representation as a written statement, to which a qualified electronic signature has been affixed, makes full proof of the statements attributed to its author, without prejudice to the complaint and proof of the falsity of the document. When it is not liable to representation as a written statement, the electronic document to which a qualified electronic signature has been affixed has probative force of mechanical reproductions. The evidential value of an electronic document to which a qualified electronic signature has not been affixed is assessed under the general law, unless there is a valid agreement in different directions.

With the greater regulatory burdens placed on ADR issuers by the Sarbanes-Oxley Act of 2002 (U.S. securities law requiring additional disclosure, stricter corporate governance standards, more timely reporting deadlines, increased regulation of the audit process, creation of audit oversight committees, audit firm registration, and stronger violation penalties.

In the recent past, ADRs were regularly used by Non-U.S. issuers to create liquid U.S trading markets as well as equity compensation for merger and acquisition transactions. Currently, ADRs may be issued pursuant to either sponsored programs - both publicly traded and privately placed securities - or unsponsored programs, established by depositaries independent of the foreign issuer which are rarely created today. This is important due to the current recession in Brazil which makes the structure of ADRs attractive for Non-U.S. investment.

However, many issuers find that the benefits of an ADR program – visibility, access to an unparalleled pool of capital, greater liquidity and the chance to attract institutional investors prohibited from purchasing ordinary shares on Non-U.S. exchanges – far outweigh the more stringent regulations.

Non-U.S. companies have cited stiffer standards as an opportunity to differentiate themselves. Other good reasons for Non-U.S. issuers to rise to the challenges of Sarbanes-Oxley and listing requirements of U.S. exchanges include the possibility of financial rewards to Brazil.
References


NOTES:

[1] It is important to understand the historical numbers on 2006. This entire database is from Brazil’s Stock Exchange official site. Available at: <http://www.bovespa.com.br>. Access on June, 21st 2014.


[6] The Rule 144A enables issuers to access more readily the U.S. institutional capital markets: A) Securities offered in the Rule 144A market do not have to be registered under the Securities Act of 1933; B) Issuers of Rule 144A securities do not have to comply with the periodic reporting requirements of the Securities Exchange Act of 1934 but do have an obligation to make certain financial disclosures to investors. This obligation can be satisfied by compliance with the information exemption available pursuant to Rule 12g-1-2 of the Securities Exchange Act of 1934; C) The reduced registration and reporting requirements associated with Rule 144A securities enable issuers of RADRs to raise capital in the U.S. private market at a cost comparable to that of raising capital in the Euromarkets; D) The time required to complete a U.S. equity private placement is less than with a registered offering, and E) A Rule 144A offering can be made with any class of shares that is not (i) listed on a U.S. securities exchange or quoted on a U.S. automated interdealer quotation system, or (ii) issued by a company that is required to register as an “investment company”. A private placement of DRs may enable Non-U.S. issuers to assess investor appetite for their securities before listing or publicly offering their DRs to the full spectrum of investors. The full text of the Act is available at the U.S. Securities and Exchange Commission website: <http://www.sec.gov/about/laws/soa2002.pdf>. Access on June 5th, 2014.


[9] Idem SEC Database.

[10] Idem SEC Database.


[12] Idem SEC Database.

[13] The International Corporate Governance Network - ICGN - is an unincorporated, not-for-profit association under the laws of England and Wales. It has four primary purposes: to develop
and encourage adherence to corporate governance standards and guidelines; to provide an investor-led network for the exchange of views and information about corporate governance issues internationally; to examine corporate governance principles and practices; and to generally promote good corporate governance. Summary from International Corporate Governance Network. Available at: <http://www.icgn.org> Access on June, 13th, 2014.


[15] Idem ICGN Database.

[16] Brazilian Securities Commission – CVM - is submitted to the Constitution and the Laws issued by the National Congress, according to article 62 of Brazil’s Constitution. Therefore, Law nº 4595/1964 created and gave normative powers to the National Monetary Council – CMN -, the highest regulatory entity within the National Financial System. The rules issued by the CMN, namely Resoluções (Resolutions), must be complied with by all the members of the System, including the Central Bank and the CVM itself. The CVM, in turn, has the power to issue complementary rules to the Laws and CMN Resolutions. The more relevant rules issued by the CVM are named Instruções (Instructions) and Deliberações (Deliberations). The main Laws that guide the securities market, and therefore, the CVM, are: Law nº 6.385 of December, 7th 1976, the "Securities Law", which disciplines the securities market and creates the CVM and Law nº 6.404 of December, 15th 1976, the "Corporation Law". Source at Brazilian Securities Commission. Available at: <http://www.cvm.gov.br>. Access on June 27th, 2014.


[18] Idem CVM Database.

[19] Idem CVM Database.


[22] Idem BOVESPA Database.

[23] Idem BOVESPA Database.

[24] Idem BOVESPA Database.

[25] Idem CVM Database.

[26] The high level and persistency of intermediation spreads has become an important source of concern for Brazilian policy makers and researchers, with good reason. High spreads are much more than a nuisance to the conduct of business. They mean high, and often more volatile, lending rates, leading to a higher cost of capital, reduced investment, and a bias towards short-term high-risk investments, away from long-maturing investments with higher social returns. Moreover, high banking spreads can disproportionately hurt small and medium enterprises and encourage informality. More generally, high spreads can be interpreted as a symptom of a poorly functioning financial system which, of itself, can retard economic growth. Improving the functioning of the financial system is arguably a much higher priority for development policy in Brazil than in other countries to the extent that the binding constraint to investment and growth is the shortage of finance rather than the lack of high-return investment opportunities (GONÇALVES, HOLLAND and SPACOV, 2005, w/p.).