

## **Portuguese methods of improving corporate governance**

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### **Overview**

Experience has shown that a country's economic performance is closely linked to efficient corporate management, particularly of public companies whose importance to economies all over the world has grown dramatically over the last decade. European countries in general, and particularly Portugal, have therefore increased their efforts towards to create a legal and regulatory framework which ensures that public corporations adopt efficient and balanced corporate governance procedures.

The legal framework corporate governance in Portugal is contained in numerous provisions of the Portuguese Companies Code and the Portuguese Securities Code.

In 1998, conscious of its regulatory and supervisory role in improving the corporate performance of public companies and promoting the integrity and stability of financial markets, the supervisory entity of the Securities Market's (the Portuguese Securities Market, or CMVM) issued a series of recommendations. These emphasised certain aspects of the legal framework for public companies' governance and added some further details to aspects of corporate governance which had only been perfunctorily regulated by the aforementioned provisions, if at all.

We will first analyse the provisions of the Portuguese Companies Code which contain regulations concerning aspects of corporate governance, elaborating briefly on each of those aspects. We will then focus on the provisions of the Securities Market aimed at promoting and refining the sound and accountable practice of corporate governance. In part three contents the CMVM's recommendations will be set out and in part four emphasis will be placed on the role of the institutional investor and on the part played by investment funds. In part five we will conclude how good corporate governance can promote the attractiveness of markets by encouraging foreign investment, helping to achieve economic prosperity in an efficient and sound manner.

### **1. Provisions on corporate governance contained in the Portuguese Companies Code (as approved by Decree-Law no. 262/86 of 2<sup>nd</sup> September 1986).**

This Code regulates the following aspects of corporate governance:

- a) Exercise of shareholder voting and representation rights;
- b) The right to distribution of profits;
- c) The right to information;
- d) Structure and role of the Board of Directors and of the Executive Committee;
- e) The Directors' duties and fiduciary powers;
- f) Regulation and supervision in case of conflicts of interests.

### **1.1. Exercise of shareholder voting and representation rights.**

Articles 380 and 381 of the Portuguese Companies Code minimally provide for the exercise of shareholder voting and representation rights by regulating proxy solicitation. They can be summarised as follows:

- i. Article 380 (1) states that company by-laws may not prevent voting by proxy, provided that the proxy is granted to a board member, another shareholder or to the shareholder's spouse, *ascendant* or descendant;
- ii. Article 380 (2) states that the proxy must be granted through a letter addressed to the Chairman of the General meeting;
- iii. Article 381 governs proxy solicitation to more than five shareholders as follows:
  - a) The proxy is valid only for a specific General meeting, whether it was convened at the date scheduled in the notice of meeting or a second date after the lack of necessary *quorum* was verified (Article 381(1a));
  - b) The proxy can be revoked by the grantor and must be considered as such if the grantor attends the General meeting (Article 381(1b));
  - c) According to Article 381 (1c), the proxy for representation must contain at least an indication of the date, time, location and agenda of the General meeting, detailed information on the person or persons who are to act as procurers and on the procurers' voting intentions in the absence of voting instructions and they must mention that in unforeseen circumstances the procurer shall vote in the best interest of the grantor;
  - d) Article 381(2) forbids proxy solicitation by board members;
  - e) Article 381(3) states that only a person who is entitled to vote, whether in person or by proxy, or a company director or manager, can be nominated as representative;

- f) Article 381(4) rules on the circumstances in which the requesting person is entitled to refuse the proxy for representation;
- g) Finally, Article 381 (4 and 5) requires representatives to address the shareholders they represent a reasoned statement of their vote in the General meeting as well as a copy of its minutes.

### **1.2. The right to distribution of profits.**

The Portuguese Companies Code does not directly require companies to disclose information on dividend policy; however, transparency on dividend distribution policy requires public companies not only to merely distribute the dividends, but also to disclose information on *how* those dividends are distributed.

The right to distribution of profits flows from Articles 21 (c) and 294 of the Portuguese Companies Code. It is perhaps the most important right of shareholders. They are entitled to at least half of the company's distributable profits; the distribution of less than half the distributable profits must be expressly authorised by company by-laws or by a special resolution approved by a  $\frac{3}{4}$  majority of shareholders.

### **1.3. The right to information.**

The rights of minority shareholders are quite extensively provided for in the Portuguese Companies Code. One important right, which is also addressed by the CMVM's set of recommendations, is the right to information:

- Under Article 288, information on, *inter alia*, management reports, general meeting minutes and announcements, the global amount of remunerations paid to directors, all relating to each of the last three years, can be made available on request to shareholders who own shares which amount to at least 1% of the share capital. This request must have a reasonable justification;
- Article 289 provides that all preparatory information for general meetings must be available for shareholder's consultation at the company's headquarters during the 15 days prior to the General meeting;

- Article 290 states that the shareholder may request the disclosure of detailed information on the items discussed at the general meeting, while it takes place;
- Under Article 291 shareholders who own shares totalling 10% of the share capital may request written information on corporate issues from the company management or the board of directors. The request must be made in writing. Information may not be refused if it is intended to assess management performance and this intention is stated expressly on the request.

#### **1.4. Structure and role of the Board of Directors and of the Executive Committee.**

##### **1.4.1. Management structure.**

According to Article 278 (1) of the Portuguese Companies Code, public companies must adopt either an unitary system management system, which is managed by a *Conselho de Administração* (Board of Directors) or sometimes by one Director overseen by a *Conselho Fiscal* (Audit Committee) (Article 278 (1a)), or a two-tier system in which management powers are shared between a single manager or a Board of a maximum 5 managers and a *Conselho Geral* (Advisory Board) overseen by a single external auditor (Article 278 (1b)).

In the first system, the *Conselho de Administração* is the sole managing body (unless an executive committee has been created as we will explain below). Its members are nominated and/or dismissed by the shareholders in a General meeting. In the second system, executive management is left to the managers, who are nominated and/or dismissed by the *Conselho Geral*, which in turn is empowered by Article 441 of the Companies Code, *inter alia*, to examine the company's books and accounts, fiscalise the managers' activities, approve the managers' annual report, submit its own annual report to shareholders, grant or deny its consent to share transfers wherever such consent is required by company by-laws and to convene general meetings whenever appropriate.

Both the Audit Committee and the single external auditor are empowered by Article 420 of the Companies Code, *inter alia*, to fiscalise the company's

managing body's activities as well as the company's books and accounts, to deliver an opinion on the management's annual report and to certify the company's books and accounts before tax and administrative authorities.

The two-tier system indicated above has had little success in Portugal; almost all Portuguese public companies prefer the unitary system.

#### **1.4.2. The Executive Committee.**

Under Article 407(3) of the Portuguese Companies Code, corporations that adopt the unitary system described above can, however, create - through their respective by-laws - a second management body, called the *Comissão Executiva* (Executive Committee).

According to article 407 (4), the Executive Committee's powers are those delegated by the *Conselho de Administração* (Board of Directors), except the powers referred to in article 406 (a) to (d), (f), (l), (m) - the powers to decide on, *inter alia*, co-optation of members as well as the election of the Chairman of the Board of Directors, convening of general meetings, mergers and acquisitions, relocation of the company's registered seat and increase of the share capital.

Unitary management can therefore unfold in a two-body system, in which the daily management of the company is run by a separate body other than the Board of Directors, leaving the "core" management decisions - those which can affect company control or assets and thus company or shareholder interests - to the latter. This system can prove useful in complex corporate structures, whose Boards of Directors often have a large number of members.

#### **1.4.3. The relationship between the Board of Directors and the Executive Committee.**

As regards the regulation of the relationship between these two corporate bodies, Article 407 (5) of the Companies states that the Board of Directors can make decisions on matters delegated on the Executive Committee and that the former may be held liable for the latter's performance.

As a consequence, the relationship between the Executive Committee and the Board of Directors is almost entirely left to company by-laws and internal procedures.

### **1.5. The Directors' duties and fiduciary powers.**

Under Article 64 of the Portuguese Companies Code, managers, directors and other key executives are bound to a duty of diligence in their activities and are also required to act in the best interest of the company and to take into consideration the interests of the company's shareholders and employees.

The fiduciary duty broadly provided for in this provision is regulated in detail as regards "self-dealing", i.e. dealing between the company on the one hand and its directors or managers on the other hand, as it is perceived by the legislator as the largest source of potential or actual conflicts of interest between public companies and their respective managers or directors.

### **1.6. Regulation and supervision in case of conflicts of interest.**

The Portuguese Companies Code contains several provisions on conflicts of interest between directors or managers and the company:

- a) Under article 397, companies may not conclude certain types of contracts with their directors or managers (for instance, the former cannot grant loans or make advance payments of more than the value of one month's salary to the latter). Contracts other than those prohibited are not invalid if they have not been previously and expressly authorised by the Board and by the Audit Committee;
- b) Directors or managers are also prevented by Article 398(1) from concluding any labour or service agreements with their respective companies or with companies in a dominion or group relationship with the former, either during the nomination period or to enter into force immediately after the said nomination. If such contracts are concluded before the director's or manager's nomination, they are automatically suspended or terminated if they have been concluded more than a year before the appointment (Article 398 (2 and 3));
- c) Competition between directors or managers and their respective companies is forbidden by Article 398 (3 and 4): the former may not carry out, either for himself or on behalf of a third party, any activity which may compete with the latter unless expressly authorised to do so by a General meeting

resolution. The term “competitive activity” is defined under Article 254 (2 to 6);

- d) The nomination of managers in companies with a two-tier management structure is subject to a number of restrictions, laid down under Articles 425 (5) and 437 (1). Managers cannot be nominated, *inter alia*, from members of the *Conselho Geral* (Advisory Board), from members of audit committees of companies which stand in a dominion or a group relationship with the company in question or from relatives of incumbent managers.

The Code does not directly require internal control committees to carry out supervision of conflicts of interest. Such supervision is left *either* to the Board of Directors *or* to the shareholders.

## **2. Provisions of the Portuguese Securities Code (as approved by Decree-Law no. 386/99 of 13<sup>th</sup> November 1999)**

The Portuguese Securities Code also contains provisions on corporate governance. Some of these improve or add new features to the provisions of the Companies Code described above. Others relate specifically to the governance of public companies.

### **2.1. Improvements and additional features to existing Companies Code provisions on corporate governance**

#### **2.1.1. Shareholder voting and representation rights.**

Article 22 of the Securities Code adds a new way of exercising shareholders’ voting rights: the postal vote. According to Article 22 (1), the right to vote in relation to matters that have been mentioned in the respective notice convening the General meeting can be exercised by mail. This provision can be waived by company by-laws, except in relation to amendments of the same and the election of managers, directors and other key executives (Article 22(2)). Article 22(3) requires that the notice convening the General meeting contains both an indication that the right to vote may be exercised and a description of the procedures for voting by mail. Under Article 22 (4), the company is required to certify the authenticity of the *outcome of the vote and to ensure it is treated in confidence until after the voting had finished.*

Article 23 developed the principles of proxy solicitation enshrined in Articles 380 and 381 of the Portuguese Companies Code. The former provision

has added new features to the procedures for the proxy solicitation of more than five shareholders as provided for in Article 381 (1) of the Companies Code. Thus, it states that besides the elements referred to in Article 381(1) item c), the proxy for representation must contain the voting rights that are attributed to the grantor and the basis upon which the vote is to be exercised by the requesting person.

### **2.1.2. The right to information.**

Since the right to information is an essential means for investor assessment of public companies and for the equal treatment of shareholders, the Securities Code contains a large number of provisions concerning the duty of public companies to provide information. The most important are the following:

- Under Article 16, whoever acquires a qualifying holding participation in a public company must disclose information on such a holding both to CMVM and to the investee company. In turn, the latter is obliged under Article 17 to publish such information;

- Article 19 requires public companies to disclose to the CMVM all shareholder agreements that aim to acquire, maintain or reinforce a qualifying holding participation in a public company or to secure or frustrate the success of a takeover bid;

- Articles 244 to 250 regulate in detail public companies' duty of disclosure of relevant facts to the CMVM and to the public;

- Article 123 describes the information that should be contained in public offer announcements in general;

- Article 181 governs the duty of a public company targeted by a takeover bid to provide information.

CMVM Regulation no. 11/2000 of 23<sup>rd</sup> February 2000 amended by CMVM Regulation no. 24/2000 of 19th July 2000 also contains procedures for the disclosure of the type of information referred to in the provisions summarised above.

## **2.2. Specific Securities Code provisions for the governance of quoted companies.**

The above provisions relate to features of corporate governance also focused on by the provisions of the Companies Code. However, the Securities Code also provides for other specific aspects of the governance of public companies.

### **2.2.1. Takeover bids.**

The issues of transparency and accountability in corporate governance arise whenever a takeover bid is at stake. Indeed, the behaviour of the target company's behaviour during the takeover bid is crucial to the latter's success. Therefore, Article 181 binds the target company's management to a tightly regulated duty to provide information to the company's shareholders and employees and the CMVM. This anticipated the principles laid out in the proposal for a 13<sup>th</sup> Directive on Company Law (takeover bids Directive) recently rejected by the European Parliament.

On the other hand, Article 182(1) deals with the target company's management duties during the period of an offer of over two thirds of the securities of the respective category. Thus, with the exception of the day-to-day management of the company, the target company's management may not behave in any way that materially affects the net asset situation of the target company or which may significantly affect the objectives declared by the offeror. Article 182(2) defines such behaviour as: the issuing of shares and other securities which confer the right to subscription or resolution and the completion of contracts involving the sale of important parts of company assets. It thus forbids, in principle, the use of two classical anti-takeover devices ("poison pills"): issuing a large block of new shares to a friendly third party and disposing of the so-called "crown jewels".

However, under Article 182(3) these devices may be used with authorisation expressly granted through a resolution passed at a General Meeting convened during the period of the offer for that purpose. They may also be used if the disposal of the said assets results from the fulfilment of obligations assumed prior to knowledge of the offer's launch. The Securities Code enshrines herein the principle laid out in the proposal for 13<sup>th</sup> Directive. According to these the management may not take any measure to counter a takeover bid unless expressly authorised by the shareholders at a General meeting.

### **3. The CMVM's recommendations on corporate governance.**

The following five recommendations published by the CMVM encompass all aspects of corporate governance focused in on parts 1 and 2 above:

- h) Exercise of shareholder voting and representation rights;
- i) Disclosure of information;
- j) Structure and role of the Board of Directors;
- k) Company internal regulations on conflicts of interest and takeover bids;
- l) Institutional investors.

#### **3.1. Exercise of shareholder voting and representation rights.**

The CMVM has issued two recommendations on this subject: firstly, it recommends that Portuguese public companies adopt measures to encourage shareholders to exercise their voting rights and to fight the absence of shareholders which too often plagues General meetings, namely by implementing procedures for postal voting. Secondly, it recommends the implementation of procedures for voting by proxy that ensure the shareholder is provided with clear and complete information on the matters to be discussed and voted on in the General meeting. This will enable the share-holder to give accurate voting instructions. The representative is also required to provide the shareholder with a reasoned statement explaining the reasons for his vote. These procedures should apply to all cases of voting by proxy as well as those already provided for in Article 381 of the Companies Code (representation of more than five shareholders);

In a further effort to encourage public companies to permit voting by mail at General meetings, in early 2000 the CMVM pulished a new recommendation only considering voting by mail.

#### **3.2. Disclosure of information.**

The CMVM recommends that public companies should disclose information on the following:

- a) *The company's structure*, namely about the division of responsibility between the company's different departments using flowcharts or functional maps. Special decision procedures, such as those regarding the company's strategic

- options, should also be disclosed. This develops the duties of information contained in the Companies Code and summarised in paragraph 1.3 above;
- b) *The functions of each member of the board of directors* as well as their position in other companies. This information is deemed essential to avoid conflicts of interests, as the assessment of such conflicts largely depends on the scrutiny of the shareholders;
  - c) *Summarised information on share market behaviour* at least once a year, including relevant facts like the issue of shares, the announcement of results or the payment of dividends per category of share and company policy on distribution of dividends. The Companies Code does not directly require this and although it appears essential for an investors' assessment of the investee company's performance;
  - d) *Shareholder agreements, whenever they concern* the exercise of rights or the transfer of shares, apart from agreements whose disclosure is required by article 19 of the Securities Code;
  - e) *Preparatory documents for General Meetings and of financial information* through the use of the new technologies. The CMVM encourages the use of the Internet to disseminate the documents and/or information referred to. This is not only seen as a way to organise cost- and time-efficient General meetings but also as a response to the increased globalisation of financial markets.

Finally, the CMVM recommends the creation of *investor information departments*, in order to ensure permanent contact with investors by enabling them to retrieve information on the company without complying with the legal requirements for the request for information.

### **3.3. Structure and role of the board of directors.**

The CMVM has issued the following four recommendations on this subject:

a) *Board composition and function* – the CMVM recommends herein that the board composition be designed to guarantee its maximum efficiency when managing the company. Board members are also encouraged to attend all board meetings (which should be regularly convened) and act diligently and with independence when making their decisions;

b) *Executive Committee* – as described in paragraph 1.4.3. above, the relationship between the Board of Directors and the Executive Committee is almost

entirely left to company by-laws and/or internal procedures; The CMVM therefore recommends that the relationship between these two bodies be governed by carefully drafted internal company procedures, which ensure, in accordance with the principle of transparency, that the Board of Directors is permanently and fully informed of the Committee's activities;

*c) Independent Board and/or Executive Committee members* – the nomination of independent board member, i.e. those not connected to major shareholders, is recommended in order to prevent corporate decisions only being made in accordance with the interests of the majority of shareholders and also to ensure that the same decisions are taken in the best interest of the company. Thus the CMVM recommends that Executive Committee members be nominated to the executive committee in accordance with the existing balance between independent and non-independent members of the Board of Directors;

*d) Internal control committees* - the CMVM recommends the creation of internal control committees for the assessment of matters from which potential or actual conflicts of interests may arise. These might include the nomination of directors and managers, remuneration policy and assessment of corporate structure and governance.

### **3.4. Company internal regulations on conflicts of interest between directors and the company, the directors' duties and takeover bids.**

A third measure recommended by CMVM to avoid conflicts of interest is the adoption by public companies of detailed internal procedures concerning conflicts of interest between the directors and the company and on the formers' duties of diligence, loyalty and confidentiality.

As shown in paragraph 2.1.3. above, the Securities Code contains detailed provisions on the behaviour of the management of a public company targeted by a takeover bid. The CMVM recommends that public companies should be careful not to include takeover devices forbidden by the Securities Code in their respective by-laws and or/ internal procedures.

### **4. The role of institutional investors and the part played by investment funds.**

Institutional investors were considered for the first time under Article 30 (1) of the Securities Code.

This provision does not define the notion of institutional investor rather it lists a number of entities which can be considered institutional investors, namely credit institutions, collective investment institutions and their respective managing companies, insurance companies and pension fund managing companies.

Institutional investors' independent and critical analysis of the company's performance may provide a valuable assessment of the performance of the companies they invest in. Such scrutiny may also act as a stimulus for the company's management to improve its own performance.

The CMVM therefore recommends that institutional investors should make an active and diligent use of their voting and information rights.

The CMVM also recommends that institutional investors disclose information on their policies towards the securities which they were entrusted to manage. This recommendation is addressed, in particular, to investment funds which are bound to a duty of transparency before the participants in the fund.

## **5. Good corporate governance and foreign investment.**

The provisions and recommendations examined above are a result of the efforts of both the Portuguese *government* and the supervisory entity of the Securities Market to set high standards of corporate governance in the Portuguese financial market. The Securities Market supervisory entity also closely follows the application of corporate governance standards set by law and due to its own recommendations. Not only does it suggest that public companies include the extent of their compliance with its recommendations in their annual report, but it also conducts annual surveys of the financial markets in order to assess public companies' compliance with the said recommendations.

The efforts mentioned above are not simply of importance to national investors. The increasing globalisation of financial markets has heightened the role of foreign investors who often favour investment in stable, low-risk markets that are based on economies which perform well.

The recent financial crises in Asia and elsewhere have made clear that inept and secretive corporate governance combined with nebulous company control schemes translates into a poor economic performance by public companies. *This leads to an*

*unstable economy in the country where the public companies are based, consequently undermining the confidence of investors who shy away from such markets.*

High standards of corporate governance are therefore of *paramount importance in establishing the economic stability desired by foreign investors. This ultimately means that by improving corporate governance, a country will also be improving the performance of its own economy.*