

THE ROLE OF CORPORATE GOVERNANCE AND DIRECTOR'S LIABILITY IN THE CONTEXT OF A SALE OR BUSINESS

By Maria Antónia Cameira (2003)

1 – Is “Corporate Governance” a meaningful term in the context of M&A transactions?

Corporate Governance is a meaningful term in the context of M&A transactions, from the very initial stages of the decision-making process.

In fact, if the decision to proceed with any given investment in the context of M&A is fundamentally influenced by the good economic performance of the target, the effective application of the corporate governance principles has nowadays a decisive impact.

Corporate governance matters have also significance during the several stages of the M&A proceedings, both in public and private transactions, raising different issues accordingly.

Basically, corporate governance issues will cover rights and duties of both the offeror and of the target during the transaction and will deal with investigation of corporate governance compliance by the target.

Corporate governance matters raised during preliminary talks in a public takeover transaction concern, fundamentally, duties of secrecy on the terms of the deal prior to the publication of the preliminary announcement to launch a takeover bid. Corporate Governance matters at this stage also comprise rules specially conceived to prevent insider dealing and market manipulation conducts as disclosure of price sensitive information.

In private transactions, relevant corporate governance provisions on preliminary talks refer to general duties of care for the interests of the company and the shareholders, which are also applied to all stages of the transaction.

Corporate governance matters raised during negotiations concern duties of negotiating on a bona fides basis, the contents of preliminary announcement to launch a takeover bid or the offer document, duties of the board of the target company referring to disclosure of information both to the offeror and to the shareholders of the target, and duties not to frustrate the bid.

In private transactions, corporate governance matters will be dealt with in the establishment of warranties and indemnities to provide for corporate governance compliance by the target.

Frequently, corporate governance matters in public and private transactions, will include amendments to the statutes, which may involve restructure of the board, redefinition of the decision-making process within the company and amendment of the required majorities to pass resolution. They may ultimately concern protective devices enshrined in the statutes (Example: hostile takeover bid of Cimpor, the largest Portuguese cement producer, where one of the main conditions of the bid was the abolishment of the voting caps).

Corporate governance issues raised during the due diligence process mainly concern, investigation of corporate governance compliance by the target including the review of documentation and compliance with the relevant provisions of the Companies Code and wherever applicable (public takeover bids) the Securities Code. At this stage, matters of corporate governance will focus on the analysis of the model of governance, as well as on the information referring to corporate records, shareholder information, securities issuance, corporate finance, financial and tax records, details on employment and management contracts as well as information related thereto.

In a public takeover bid, during the due diligence process, corporate governance issues will mainly be reflected in the review of information and documentation available from public sources and information made available by the target. In this respect, the Portuguese Securities Code specifically imposes certain duties of disclosure on the board of the target company.

Contrary to what happens in a public takeover bid, in private acquisitions there are no specific duties imposed on directors in relation to the disclosure of information to the potential purchaser and their general duties remain the same throughout the several stages of the transaction until final completion.

Corporate governance matters associated with a merger project of either private or public companies, will concern expert's reports and board's reports on the motifs, conditions and objectives of the merger as well as in audit reports on the criteria established by the board for the swap of shareholdings in the merging companies.

2 – Do your Due Diligence Checklists cover specific aspects of Corporate Governance?

Our Due Diligence Checklist covers some specific aspects of corporate governance, as it has been updated according to the fifteen recommendations of 1999 and the Regulation 7/2001, of 28th December 2001 on corporate governance, all issued by the Securities Market Supervisory Authority (Comissão do Mercado dos Valores Mobiliários or CMVM).

-Which elements/features of Corporate Governance do they list?

The listed elements/features of corporate governance are intended to assess the level of adherence of the target and compliance with the CMVM recommendations, regulations and the relevant provisions of the Portuguese Companies Code and Portuguese Securities Code on corporate governance. Furthermore, our Due Diligence Checklist lists the following special features:

Corporate Records:

- Certificate of Incorporation of the Company or other charter document currently in effect, and all amendments thereto.
- By-laws of the Company currently in effect, and all amendments thereto.
- Minutes of the meetings of the Board of Directors of the Company, and all committees thereof and all shareholders meeting.
- The company's structure and internal decision-making process procedures.
- A chart with the members of the Board of Directors (including the executive and non-executive ones), the nomination of independent members and their balance with non-independent of either of the Board of Directors of the Executive Committee and also a report therewith comprising the total amount of Directors' remuneration.

Shareholder information:

- All communications with shareholders for the past three years.
- Shareholders agreements.
- The company dividend distribution policy and the main features of the company stock option plans.
- The existence of an investor relations department or office which ensures regular contacts with investors and disclosure of preparatory documents prior to General Meetings.

- The mode of exercise voting rights by shareholders, including proxy voting and voting by mail procedures.
- Internal regulations on risk assessment and conflicts of interest as well as on defensive devices against takeover bids.
- The existence of institutional investors and the depth and extent of information in the way they exercise their voting rights, as well as the information arising from the shareholdings they manage.
- List of all shareholders of the company owning in excess of 5% of any class of stock.
- All agreements containing registration rights or assigning such rights or agreements containing preemptive rights or assigning such rights.
- The existence of confidentiality agreements.

Securities issue:

- Samples of share certificates, warrants, options and other outstanding securities.
- Stock option or purchase plans in effect during the past five years and all forms of grant award, option or purchase agreements, which have been or may be used there under.
- All other agreements relating to the sale of securities by the Company.

Corporate Finance:

- All documents and agreements relating to guarantees by the Company, if any.
- Correspondence with lenders or securities holders, including all compliance reports submitted by the Company or its outside accountant or tax advisor.
- Schedule of notes payable and all documents and agreements evidencing borrowings by the Company, whether secured or

unsecured, documented or undocumented, including loan and credit agreements, indentures, promissory notes and other evidence of indebtedness, and any amendments, renewals, notices and waivers.

Financial Information:

- Financial and operating plans for a future period of two years, including projected income statements, cash flow and balance sheets.
- All management letters or special reports by auditors and any responses thereto.
- All unaudited interim financial statements prepared for the Board of Directors, including historical quarterly financial statements.
- Reports of all external specialists (e.g., actuaries, financial consultants, and others).
- Detailed schedule for accounts receivable and accounts payable at close of most recent fiscal quarter (when completed).
- Schedule bad debt reserves and unusual charges to operations for the past three fiscal years.
- Information on all planned acquisitions and dispositions.
- Breakdown of gross revenue, net income and total assets by country, indicating the nature of the products or services.

Taxes:

- All income tax return forms for the last five years, state and foreign.
- List of all foreign tax credits, and analysis of taxes on undistributed foreign earnings.
- List of states where target file income tax returns.
- List of VAT payments and reimbursements.
- List and copies of all transfer pricing agreements currently in effect.

- All materials relating to an audit by any tax authority including communications with such authority during the last five years. Provide revenue agent reports and analogous reports of taxing authorities in non-Portuguese jurisdictions.

Employees:

- List of employees including: name, age, date of hire, job title and description, compensation schedules (including bonuses, etc.), and other compensation prerequisites.
- Forms of employment agreements, if any and description of employment terms for employees without contracts.
- Collective bargaining agreements or other material labour contracts and description of all significant labour problems or union activities.
- Description of commissions paid to managers, agents or other employees since incorporation of the Company.
- Copies of all employee benefit programs.

Officers, Directors and Employers:

- Management employment agreements, compensation agreements and “golden parachute” agreements, if they exist.
- Schedule of all compensation paid during the last four fiscal years to officers, directors and key employees showing separately salary, bonuses and non-cash compensation (e.g., use of cars, credit cards, etc.).
- All additional bonus plans, deferred compensation plans, profit sharing and management incentive agreements.
- All agreements with officers and directors (current and former) including, without limitation, loans and consulting contracts.

- Description of any related party transactions. Relationship and business purpose of such transaction.
- All agreements with any present or former director, officer or employee regarding termination or severance.

Litigation and Audits:

- List of outstanding, pending or threatened litigation, arbitration, administrative proceedings, and investigations, identifying the respective parties, the nature of the claim, and the value at stake. It should include details of the claimant/defendant, claimed damages, including any products or patents in dispute (whether owned by the Company or not), brief history, status, and anticipated outcome.
- Complaints, orders or other significant documents in pending or threatened matters involving claims of € 50.000,00 or more.
- All other information regarding all material litigation to which the Company is a party or in which it may become involved.

Joint venture, reorganization and acquisition agreements:

- Copies of joint venture agreements.
- All agreements, plans documents relating to consolidations, reorganizations or dispositions of any assets or lines of business of the Company within the last five years.

Governmental regulations and filings:

- Permits or licenses for conduct of business.

- All CMVM filings by the Company, including registration statements, reports, comment letters, responses or other correspondence with the CMVM.

In addition to the points listed above, a list of consents or approvals for the proposed transaction must be enclosed.

- **What will the Due Diligence examination cover, rather the formal (documented) standard or the standard practiced by directors?**

The Due Diligence examination covers the formal (documented) standard. However, the standard practiced by directors is often considered in this examination, as it will mirror the status of the effective level of the corporate governance compliance of the target.

Nevertheless, it must be taken into consideration that there is no “right” and “wrong” way of performing due diligence since what suits one client may not be adequate for another. Therefore, whether the Due Diligence examination covers the rather the formal standard or the standard practiced by directors will depend on the specific characteristics of the type of deal in question. A complete due diligence examination will, in many circumstances, combine successfully, both formal documented standards and standards practiced by directors.

- **What will be the benchmark of good Corporate Governance in a transaction: the standard prevailing at the place of business of the country of the selling shareholder (if distinct) or the country of the acquirer (if distinct)?**

Both the Portuguese Securities Code and Portuguese Companies Code contain special provisions on the applicability of the Portuguese Securities Law and Company Law to all matters referring to private and public companies. The

Portuguese Securities Code states that its provisions are applicable to all matters referring to public takeover bids of Portuguese Companies and the Portuguese Companies Code provides that it will apply to companies that have their head office in Portugal. These provisions do not allow the application of foreign rules concerning M&A procedures, which necessarily involve corporate governance issues. Therefore, the benchmark of good corporate governance in an M&A transaction, concerning a Portuguese company, will be the legal standards prevailing in Portugal. Nevertheless if the prevailing benchmark in the country of the acquirer reflects more developed and structured patterns of corporate governance, the assessment of corporate governance compliance will inevitably be influenced by them, acting as boosters of corporate governance principles and rules in the incoming investment country.

An important fact to take into consideration in the answer to this question is that all the OECD countries have updated their corporate governance legislations according to the OECD principles, which provide an international benchmark that accommodates different national models and facilitates the development of best practices by the private sector. Although these principles are non-binding, they represent what OECD countries regard as the core elements for good corporate governance. These principles are expected to be applied, in accordance with national and corporate specific circumstances. Therefore, OECD countries tend to have similar benchmark standards on corporate governance, which implies a convergence, at least of the core guiding principles.

- Who is likely to answer these questions (board members? Officers? Shareholders?)?

Those more likely to answer these questions are the members of the management bodies, namely the Board of Directors, assisted by technical advisers (lawyers, investment bankers, accountants are obvious examples). This

team will ideally get together before the request is delivered to ensure that the request addresses their specific areas of interest.

It is essential to restrain the access to vital information to specific persons during the due diligence process and the nomination of a due diligence coordinator is recommended. In fact broadening the circle of people who handle the information may increase the risk of leaks.

The answers to the due diligence request (checklist) must be as specific and tailored as possible, whether the request is global or targeted, generic or detailed.

In private transactions, shareholders may be more likely to answer these questions since they will be inevitably and directly involved in the negotiations and have therefore, detailed knowledge on the conditions and terms of the deal.

3 – Does any worker’s representation (e.g., works council, union) have a say in your country in the context with Corporate Governance matters?

Worker’s representation at board level is expressly provided for by the Constitution and by the Law on Worker’s Committees, according to which workers have a say in corporate governance matters.

Board level employee representation involves employees’ representatives who sit in the different boards that compose each management structure. For companies that have adopted the unitary system, employee’s representatives (one at least) will sit in board of directors (*Conselho de Administração*) and in the Audit Committee (*Conselho Fiscal*). For companies who adopted the two-tier

system, employee's representatives will sit in the board of managers (*Direcção*) and Advisory Board (*Conselho Geral*).

These representatives are elected by the workers and chosen among them. However, this type of representation is only mandatory in the case of state owned companies.

In the case of private sector this appointment is optional and will fundamentally depend on previous stipulation of the parties involved.

A study carried out by the European Industrial Relations Observatory on board-level employee representation in Europe points out that in Portugal, in practice, this legislation has not had any impact in corporate governance practices and that there is little or no implementation of such legal provisions. In fact and according to the same study, there are no known cases in which employees' representatives have been appointed to a company's board, either in public or private companies.

4 – Does a public takeover raise Corporate Governance issues different from a private transaction?

A public takeover raises different corporate governance issues from a private transaction. These outlining differences are apparent during the several stages of both public and private transactions.

Corporate governance matters raised during the preliminary talks leading to a takeover bid refer to the duty of confidentiality that binds all parties involved, that is to say directors of the offeror and of the target company, shareholders, members of the companies bodies and all those who render services on a permanent or occasional basis, until the publication of the preliminary announcement.

It is worth mentioning that there is no formal obligation of the Board of the offeror at this stage, to disclose its intention to launch a takeover bid to the target company, prior to the effective launching.

During the due diligence process, corporate governance matters will refer to corporate governance compliance by the target company and specially to the analysis of the model of governance, as well as on the information referring to corporate records, shareholder information, securities issuance, corporate finance, financial and tax records, details on employment and management contracts as well as information related thereto.

When analysing special attention will be given to the balance between dependent and independent directors, board structure and decision-making process, directors compensation policy, dividend policy and company stock option plans.

The review of information will be mainly from public sources but in a friendly bid will also be exercised on the information voluntarily disclosed by the target.

The disclosure of information contained in this report, issued by the target's board, will not specifically focus on corporate governance matters and its major contents requirements will reflect to a great extent the information obligatorily supplied at this stage by the target.

It is noteworthy that, according to CMVM's regulation 7/2001, listed companies must publish a report on corporate governance, which must be included or annexed to the annual management report.

This report must be publicly available and will include information on the form and level of compliance with the CMVM's recommendations, organisation charts or diagrams of the board structure and decision-making process, description of the developments on the quotation of shares in the issuing company, distribution of dividends, policy plans for the allotment of shares and stock options, data concerning the use of new technologies, Investor Relations Department, exercising of voting and representation rights and company internal regulations. In a public takeover bid the review of information will also include this report.

In a private acquisition or merger, the due diligence process, as far as corporate governance matters are concerned, will mainly focus on review of documentation provided by the vendor relating to corporate governance compliance, as well as information that may be publicly available at the Companies Registry. Review of corporate records as well as tax and financial information will be carried out. The purchaser will ensure that required notifications under the provisions of the Companies Code and provisions referring to corporate governance matters have been complied with, namely the consent of the company to the transaction and in certain cases also the procedures referring to pre-emption rights of the existing shareholders.

In the acquisition of a private company there are no specific corporate governance rules on either the offeror's or the target's disclosure duties. Corporate governance issues may be raised directly in relation with drafting of documentation, especially when warranties and indemnities are agreed to cover occasional deficiencies in corporate governance by the target.

With publication of the preliminary announcement to launch a takeover bid, corporate governance matters will refer to the contents of the document offer which must provide a level playing field to all shareholders, duties of disclosure concerning shares held either in the target by the board of the offeror, third

parties on its behalf, or any persons or entities with whom it has special privileged relationships.

Negotiations concerning specific corporate governance issues will deal with warranties and indemnities designed to cover any occasional deficiencies in corporate governance compliance by the target.

The special duties to which the board of the target is bound after the publication of the preliminary announcement, also bring about relevant corporate governance issues. In fact, after the publication of the preliminary announcement, the Portuguese Securities Code imposes to the board of the target the obligation of presenting a detailed report regarding the opportunity and conditions of the offer, which must be sent to the Supervisory Market Authority and to the offeror containing detailed financial information and feasibility study reports by an auditor registered with the CMVM.

The board of the target company shall, from the publication of the preliminary announcement until the assessment of the result of the offer, inform the CMVM daily of the transactions carried out by its members, or those who have qualifying holdings. It shall also supply all the information required by the CMVM within its supervisory functions and inform its employees of the contents of the document offer. Moreover, the board of the target company is bound by special duties to act on a bona fide basis, at all time.

The Portuguese Securities Code also expressly prohibits the board of the target company from practicing acts that may materially affect the net asset situation of the company, thus frustrating the objectives announced by the offeror. Furthermore, when the board of the target becomes aware of the decision to launch a takeover bid it can only practice acts of day-to-day management. Acts resulting from the compliance with obligations assumed before the board becomes aware of the offer launch and acts authorised by resolution approved by

a special majority of $\frac{3}{4}$ of the share capital, at a General Meeting specifically convened for that purpose during the period of the offer, are exceptions.

These provisions were specially conceived to avoid defensive devices against takeover bids incompatible with shareholders interests, which could automatically decrease the company's assets value (the so-called "*poison pills*", disposal of "*crown jewels*" and also the so-called invitation of a "*white knight*").

Furthermore, the offeror is also bound by special duties being responsible and it is responsible for damages incurred as a result of the decision to launch a takeover with the main objective of placing the target company in a day-to-day management situation.

Minority shareholders' rights are also protected by relevant corporate governance provisions of the Securities Code. Shareholders, who, after the launch of a takeover bid, hold directly or indirectly, more than 90 % of the voting rights of the share capital of the target company, can acquire the remaining shares within 6 months of the closing date of the offer (compulsory takeover bid or "squeezing out mechanism"). Should the abovementioned shareholder fail to put forward a proposal to buy out the minority shareholdings, each of the minority shareholders can invite the former in writing to make an offer for its shares ("compulsory sale mechanism"), which is effective from the date of notification by CMVM to the controlling shareholder. Moreover, in compulsory acquisition proceedings, equal treatment to holders of shares of the same class must be assured, in particular regarding to calculation of the price of the shares. The Portuguese Companies Code foresees similar mechanisms in the case of private transactions.

Mergers in general, of either public or private companies, are subject to specific duties of corporate governance concerning the merger project to be drawn by the directors of the merging companies, subject to preliminary

registration and to subsequent approval of the General Meeting. The Board of each of the merging companies must send the merger project to the Audit Committee or to an independent auditor for an opinion on the several aspects of the accuracy of the merger project.

The merger project must lay out details on any specific advantages that may be gained as a direct consequence of the merger, by either experts or board members of the merging companies.

Disclosure of the information concerning the merger project to shareholders is compulsory. Directors of each of the companies involved in a merger project are jointly and severally liable for damages to shareholders resulting from the breach of duties of verification of the status of the assets of the merging companies.

- Will board members (dependent, independent) or management follow a different approach in a public-takeover situation?

In public takeover situation, dependent or independent board members are bound by specific duties towards the offeror, the shareholders of the target and to the target itself.

Board members, independent or not, must do the following: To supply the necessary information to the shareholders and employees, treating them equally; to accurately report on the conditions and opportunity of the takeover bid to the offeror and the CMVM; to refrain from engaging in actions that can frustrate the bid, such as negotiate the securities which are covered by the bid or to negotiate the company's assets; and, always, negotiate on a bona fide basis.

These duties are imposed by provisions of the Portuguese Securities Code, which contains specific duties and obligations for the Board of the target, from the moment that the preliminary announcement is published until final results of the offer are obtained. In case of non-compliance, the board members are liable towards the shareholders, the company itself and to the offeror.

However, in a hostile takeover bid, the report on the opportunity and conditions of the offer after the publication of the preliminary announcement, which must be prepared by the target board, will inevitably, in most cases, refute the offeror's bid in its various aspects.

5 – Are these guidelines mandatory or just recommended?

These guidelines are mandatory since the Portuguese Securities Code imposes them. Non-compliance with these rules constitutes administrative infractions punishable with a fine, or administrative sanctions, or even by imprisonment in case of economic crimes. However, the existing regulatory framework is also composed of non-binding recommendations issued by the CMVM, aimed at contributing to the optimum development of companies and protecting the interests of all the shareholders in the company, particularly the interests of minority shareholders. These recommendations were not conceived with the purpose to impose rigid and uniform models. Therefore, they should be followed by board members, especially in a public takeover situation.

- **What is the content of these rules?**

Please refer to the answer to Question 4 above.

- **What role would the lawyer play?**

Lawyers perform an extremely important role in M & A transactions, which goes beyond due diligence procedures focused on specific issues or documents from the perspective of the deal. Lawyers also draw upon their experience to assist their clients in structuring the process, and such experience is instrumental to a well-informed decision-making process.

With respect to corporate governance matters, lawyers tend to be the first to be concerned about such matters and to raise related questions.

In the Portuguese legal framework of mergers and acquisitions, the role of lawyers consists exclusively of their duties towards clients in the diligent execution of their mandate, in accordance with the relevant provisions of Portuguese Code of Conduct for Lawyers. For instance, lawyers assisting a merger or acquisition will not be regarded as co-responsible if the client does not comply with duties of disclosure of material assets, liabilities or material obligations (contingent or otherwise), during the transaction, to either authorities, the target or the offeror. Effectively, in preparing documents for a public offering, the lawyer will not be responsible towards third parties, if the client fails to include in such documents any essential information, which may be material to an investor's decision to make the investment.

6 – Are there special Corporate Governance requirements for banks in your country?

In Portugal there are special corporate governance requirements for banks, which are chiefly foreseen by Decree-Law n. 298/92, of 31st December, last amended by Decree-Law n. 201/2002, of 26th September and Decree-Law n. 319/2002, of 28th December, the General Regime of Credit Institutions and Financial Companies (Regime Geral das Instituições de Crédito e Sociedades Financeiras).

The Portuguese Banking Supervisory Authority (hereinafter Banco de Portugal) is the authority that supervises the banks' compliance with corporate governance requirements. However, the CMVM has also an important supervision role with reference to listed credit institutions.

According to Law n. 5/98, of 31st January 1998, as amended by Decree-Law n. 118/2001, of 17th April 2001 (Banco de Portugal Organic Law), Banco de Portugal shall be responsible for the supervision of credit institutions, financial companies and other entities legally subject to its authority, by issuing directives, namely Notices (Avisos), published in the Official Gazette, Regulatory instruments (Instruções), published in Boletim de Normas e Informações do Banco de Portugal (BNBP), Manual of Instructions (set of Regulatory instruments in force) and Circular Letters (non-regulatory guidelines disclosed through BNBP) to guide their action and to ensure the centralisation services of credit risks. For that purpose, Banco de Portugal may require from any public or private body to supply whatever information deemed necessary for compliance with such provisions or completion of the tasks entrusted to it.

Credit institutions can only be incorporated as joint stock companies ("anónima" companies). Therefore and according to the Portuguese Companies Code, two models of governance for "anónima" companies can be adopted, namely a unitary management system or a two-tier system.

Basel Committee work papers on Banking Supervision namely, *Principles for the management of interest rate risk* (September 1997), *Enhancing Corporate Governance for Banking Organisations* (September 1998), *Enhancing bank transparency* (September 1998) and *Principles for the management of credit risk* (a consultative document in July 1999), set out important guidelines on corporate governance, which largely inspired Portuguese corporate governance provisions for credit institutions.

The Portuguese legal framework of the corporate governance of banks and other credit institutions draws extensively on the guidelines set out by the abovementioned committee, defining rules and regulations for the development of banking business by boards and senior management and describing sound corporate governance practices.

The achievement of such objective implies in the acknowledgement of the fact that corporate governance structures of banks and other credit institutions must count on the strategies and techniques for efficient oversight of the organisational structures.

Contrary to sound corporate governance it is worth mentioning that statutes of at least, two important credit institutions, foresee voting caps.

- **What is their content?**

The abovementioned rules covers important corporate governance matters involving banking organisations, following the most recent trends in European legislation, namely Directive 2000/12/EC, of 20 March 2000 and the Basel Committee recommendations.

A) – *“Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organisation”*

When applying for authorisation to operate in the Portuguese market, credit institutions are legally bound to submit a set of reports and documents that clearly set out corporate strategic objectives, as well as plans for their implementation. In particular, it must submit a full and complete programme of operations, as well as a detailed description of the structure that it proposes to develop, in order to implement such a programme and a set of prospective

accounts for each of the three business years. A well-founded report on the adequacy of the proposed share capital structure for the institution's stability must also be submitted.

If *Banco de Portugal* finds that the institution does not have the technical or financial means to fulfil the proposed corporate object, or if the institution has not complied with the abovementioned requirements, it will not authorise that institution to operate in the Portuguese banking market.

Corporate values, which are communicated throughout the banking organization, are underpinned by several legal provisions enshrined in the General Regime of Credit Institutions and Financial Companies and by credit institutions' internal regulations and codes of conduct.

These provisions contain fundamental rules of conduct for directors and employees of credit institutions in their relationships with clients, promoting diligence, neutrality, loyalty and respect of the latter's interests. They also deal with duties of disclosure in the provision of banking services.

Conflicts of interests are also addressed in these provisions, which prohibit direct or indirect loans to board members of credit institutions, as well as other forms of self dealing. They also expressly prohibit the intervention of these board members in any transaction where they may have any direct or indirect interests.

These provisions also regulate the granting of loans to holders of qualifying shareholdings, which cannot exceed 10 % of the funds of the credit institution. Furthermore, the maximum global amount of credit, in these situations, is of 30 % of the institution's funds. These operations also depend on the prior approval of at least two thirds of the Board of Directors and a favourable report of the Audit Committee of the credit institution.

The members of boards of credit institutions and their staff are bound by the duty of confidentiality regarding facts related to the institution itself and the institution's relationship with its clients.

B) – *“Setting and enforcing clear lines of responsibility and accountability throughout the organisation.”*

In order to set and enforce clear lines of responsibility and accountability throughout the organisation, credit institutions must provide *Banco de Portugal* with information on their administrative organisation, the effectiveness of their internal control mechanisms and security procedures regarding their database.

Moreover, credit institutions are encouraged to issue internal codes of conduct, which are subject to assessment by CMVM. The most recent example is the professional Code of Conduct of the Portuguese Association of Banks, which is mandatory on all member credit institutions.

C) – *“Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns.”*

The structuring of Board of Directors of credit institutions as well as the appointment of directors is subject to specific personal requirements and must fulfil certain criteria.

The members of the Board must display integrity and be qualified to fulfil the directors' duties.

The directors that intend to sit on boards of other companies must apply for previous authorisation to *Banco de Portugal*, which can be denied if it finds that this causes conflicts of interests.

Board members must register with *Banco de Portugal*, and comply with the abovementioned personal requirements.

Special committees, such as a risk management committee, a compensation committee and a nomination committee may be created by the credit institution's internal regulations.

Moreover, *Banco de Portugal* can appoint temporary directors to the board of directors of credit institutions in specific cases, such as ineffectiveness of internal control procedures, in order to ensure a proper assessment of the net asset situation of the entity in question.

D) – “*Ensuring that there is appropriate oversight by senior management.*”

Portuguese applicable provisions of the General Regime of Credit Institutions and Financial Companies stipulate that the Board of Directors of credit institutions must consist of at least three members with full powers to run the business of the institution and its daily management must be entrusted to at least two board members. These provisions intend to provide for compliance with the principle which states that key management decisions should be made by more than one person (“*four eyes principle*”).

E) – “*Effectively utilising the work conducted by internal and external auditors, in recognition of the important control function they provide.*”

The internal and external auditors provide an important control function. They ensure that the financial information is correct. They are also obliged to report any breaches to the provisions that govern the banking activity to *Banco de Portugal*.

Moreover, in the exercise of its supervisory powers, *Banco de Portugal* can request special auditing of credit institutions to independent entities.

F) – “*Ensuring that compensation approaches are consistent with the bank’s ethical values, objectives, strategy and control environment.*”

Rules concerning the compensation policy of boards members of credit institutions are mainly provided by their own internal codes of conduct.

CMVM regulation 7/2001 contains rules on the duty of disclosure of boards’ remuneration, which oblige listed credit institutions to disclose the total amount of remuneration received on an annual basis by independent and non-independent directors and distinguish fixed from variable remuneration. The validity of such compensation practices will depend on the statutes of the company and the previous approval of the shareholders.

G) – “*Conducting corporate governance in a transparent manner.*”

Communication duties, provisional opposition by *Banco de Portugal* regarding the acquisition of qualifying holdings and suspension of voting rights are relevant control mechanisms enshrined in the Portuguese legal framework on credit institutions. *Banco de Portugal* plays a crucial role in this context, as the supervisory authority of the banking activity. The acts that depend on previous authorisation of *Banco de Portugal* include amendments to statutes that govern the credit institutions and mergers or demergers.

The acquisition or increase of qualifying holdings must be communicated to *Banco de Portugal*, which may provisionally oppose such an operation within the following three months, if it concludes that the acquirer or his project does not fulfil the necessary conditions to guarantee a sound and prudent management of the credit institution.

In its assessment, *Banco de Portugal* may, in certain situations, provisionally oppose the completion of the operation, before reaching a final decision.

A shareholder is deemed to have a qualifying holding whenever he is able to exercise a significant influence in the management of the credit institution. That influence is presumed to exist whenever the shareholder holds at least 10 % of the share capital or voting rights. However, this presumption can be refuted if the holding is equal or inferior to 5 % of the share capital or of the voting rights.

Whenever an action involves an increase of a qualifying holding, so that the proportion of the voting rights, or the held share capital reaches or exceeds 5 %, 10 %, 20 %, 33 % or 50 %, or so that the credit institution becomes a subsidiary of the acquirer, *Banco de Portugal* must also be previously notified. Likewise, *Banco de Portugal* must be notified whenever the acquired holdings reach a minimum of 2 % of the share capital or the voting rights of a credit institution.

Banco de Portugal can order, at any time, the suspension of the voting rights corresponding to an acquired or increased qualifying holding, if it becomes aware of facts that may justify the conclusion that the shareholder in question will not be able to guarantee a sound and prudent management of the credit institution. *Banco de Portugal* will also determine the extent to which the suspension will include the voting rights of the credit institution in other credit institutions, with whom it maintains a domination relationship.

Credit institutions must also provide *Banco de Portugal* with reports on risk assessment and compliance with the regulations on internal control mechanisms.

The implementation of these measures aim at the control of the capability of shareholders, their integrity, the promotion of transparency and accountability

in the management of the institution and the protection of the best principles of corporate governance.

Credit institutions are also obliged to maintain adequate levels of liquidity and solvency and, accordingly, must keep reserves, which cannot be inferior to 10 % of the annual net profits.

7 – Any other branches or types of companies that have specific Corporate Governance requirements?

The leading branches of the Portuguese economy, such as insurance companies, newspaper publishers, airlines, telecommunication operators and pharmaceutical companies, also have specific corporate governance requirements regarding the ownership structure, disclosure of information, risk assessment, Board of Directors and management structure.

We will outline below the most important features of corporate governance requirements for insurance companies.

The establishment of insurance companies is subject to previous authorisation by *Instituto de Seguros de Portugal* (Portuguese Insurance Institute - “ISP”), the Portuguese Insurance Supervisory Authority. Such an authorisation can be refused if measures to ensure sound and prudent management are not taken. This authorisation depends on verification by the supervisory authority of certain requirements on ownership of qualifying holdings and the adequacy of human resources to meet the company’s objectives.

Insurance companies can be incorporated either as “*anónima*” companies or as mutual companies, of which “*anónima*” companies are the most commonly chosen.

These are two possible models of governance for an insurance company incorporated as an “*anónima*”. It can adopt either a unitary management system, in which management is carried out by a *Conselho de Administração* (Board of Directors) with an optional *Comissão Executiva* (Executive Committee) whose powers are mainly delegated by the Board of Directors, overseen by a *Conselho Fiscal* (Audit Committee), or a two-tier system, in which management powers are shared between a single manager or a board of a maximum of five managers and a *Conselho Geral* (Advisory Board), overseen by a single external auditor.

The acquisition or increase of qualifying holdings of an insurance company is also subject to communication duties. Any individual or legal entity/company, who, directly or indirectly, intends to acquire or increase a qualifying holding in an insurance company, so that the proportion of the voting rights or share capital held by that entity will reach or exceed 20 %, 33 % or 50%, or so that the insurance company will become his subsidiary, must give previous notice of its project to the Minister of Finance.

This Minister of Finance, after hearing the ISP, may oppose to the project if it considers that the entity concerned is not in a position to ensure sound and prudent management.

The acquisition or increase of a qualifying holding without compliance with the abovementioned requirements, will give rise to the suspension of the corresponding voting rights.

The conditions to guarantee sound and prudent management are presumed inexistent, whenever there is doubt as to the legitimacy of the funds used to acquire the holdings, or the true identity of the holder of funds, or the adequacy of the financial position of the person concerned in relation to the size of qualifying holding he proposes to acquire.

This presumption also exists whenever the structure and characteristics of the group to which the insurance company belongs make adequate supervision unviable and the person concerned does not implement measures set out by ISP as to the financial restructuring of the company.

Boards and auditing board members, including non-executive directors of insurance companies shall meet special requirements, such as suitable academic qualifications, professional experience and recognised integrity.

The registration of members of the insurance companies' boards and auditing at the ISP is mandatory, but can be refused for non-compliance with the abovementioned requirements.

Moreover, the ISP may also appoint one or more temporary directors of insurance companies and an auditing committee in some cases, such as when there is a risk that the insurance company will cease payments.

8 – If board members and directors are replaced at the occasion of a sale of a business: What role does principles of Corporate Governance play?

In case of replacement of board members and directors in a sale of a business, corporate governance matters will mainly focus on the issues related to the ousting and appointment of directors. The matters referring to the ousted directors will focus on the compensation package, the so-called “golden parachutes”¹, future status of pending loan agreements and negotiation of confidentiality agreements.

In the appointment of the new directors, corporate governance considerations will concentrate on the composition of the new board and the

¹ The validity of such compensation practices will depend on the statutes of the company and on the previous approval by the shareholders.

clear definition of remuneration and compensation schemes, rights and duties, conflicts of interests, rights to stock option plans.

The following principles are paramount in choosing the composition of the new Board of Directors:

- Board Leadership:

The roles of Chairman and C.E.O. are ideally separate, and the former is not held by an executive director.

- Size of the Board:

The number of directors must be appropriate to the size of the company. A great number of directors can hinder effective discussion or diminish individual accountability.

- Nomination Committee:

A nomination committee should be established within the board to recommend candidates to the General Meeting of shareholders, ensuring that all interests will be duly represented.

It is recommended that this committee is composed by independent non-executive directors.

In addition, each board member is expected to ensure that existing and future commitments do not materially interfere with the member's role as a director.

- Directors personal requirements:

Any nominees to the board of directors must have a balance of skills, experience and qualifications, which are essential to an effective decision-making body.

- Remuneration policy:

A set of procedures concerning the compensation schemes and policies should be outlined and implemented by a remuneration committee created from the Board. In addition, directors' fees should be based on independent market surveys and should be connected to profits.

According to CMVM's Regulation 7/2001, listed companies must report on regarding plans for the allotment of shares and/or stock options plans among employees and/or members of the Board of Directors. This information must include the justification for the adoption of the plan, conditions attached to the allotment, criteria concerning the price of shares and stock options, the validity of such options, the number of shares to be issued and characteristics of the same, the existence of incentives to purchase shares and/or stock options and the competence of the Board of Directors to carry out or amend the plan.

- Non-executive and independent directors:

It is recommended that the Board is also composed by a number of non-executive directors.

Their role is important in representing the interests of minority shareholders and in overseeing executive directors in financial areas and areas that affect the strategy and future of the company as well as areas where executive directors may have conflicts of interest.

Ideally, non-executive directors should also be independent. Portuguese boards however, tend to differentiate between non-executive and independent directors, and to integrate a certain number of both. Non-executive directors can be independent or not and this definition of independence linked² to the non-representation of dominant shareholders of the company.

We have recently witnessed the appointment of non-executive directors who represent one or more minority shareholders.

Independent and non-executive directors have an important role to play in appointment committees, remuneration committees and audit boards.

Ideally the majority of non-executive directors should be independent, not only from shareholders, but also from any operational business of the company.

Finally, and in line with CMVM, the appointment of independent executive directors is also recommended, in order to prevent corporate decisions from being taken only according to the interests of the majority of shareholders only and to ensure that the best interests of the company are preserved.

- Minority Shareholders' Rights:

Minority shareholders' rights and interests cannot be forgotten in the sale of a business. The replacement of Board members and directors must take into consideration an effective representation of minority shareholders, as they must not be seen simply as investors, who only contribute with funds.

² According to the 9th recommendations on Corporate Governance, issued by the Portuguese Securities Market Supervisory Authority (CMVM).

In practice, as stated above, we have recently witnessed a clear tendency, in Portuguese listed companies, to non-executive directors to represent minority shareholders in the Board.

Minority shareholders can also be protected through the implementation of provisions of the Portuguese Companies Code on the appointment of Directors³, in relation to “Anónima” companies.

In this respect, the existing provisions stipulate that companies’ statutes may provide that minority shareholders representing not less than 10 % nor more than a 20 % shareholding present a list of individuals to be appointed as directors, voting for each one separately. Furthermore, the statutes may provide that minority shareholders who voted against a list may appoint one director providing they hold at least 10 % of the share capital. The inclusion of one of these mechanisms in the statutes of listed companies is mandatory.

- Model of Governance:

The existing model of governance may also be questioned, in case of a sale of a business. In this respect, the traditional Portuguese unitary system of management, composed by a Board of Directors (*Conselho de Administração*) with an optional Executive Committee (*Comissão Executiva*), overseen by an Audit Committee (*Conselho Fiscal*), may be changed, thus reflecting efforts for the improvement of standards, transparency, probity and accountability in promoting the best practices of board effectiveness, the basic plank on which good governance rests.

In Portugal, companies have taken steps towards the improvement of the unitary system through the incorporation of some of the features of the two-tier

³ See Minority Shareholders Rights in the Portuguese Companies Code, by Maria Antónia Cameira, published in International Corporate Law Bulletin (ICLB), Kluwer Publications, vol. 2, Issue 3, March 1999.

system in this model of governance, as identified in the Portuguese Companies Code.

Such recent improvements have been made by important Portuguese companies, of which Electricidade de Portugal (EDP), the major Portuguese electricity operator, is a remarkable example. Two of the most relevant shareholders of EDP even though they are minority shareholders, namely Banco Comercial Português (BCP) and BRISA, tried to implement a new governance structure, which combined the main features of the abovementioned typical Portuguese models of governance. For instance, a new board, a so-called *Conselho Superior* (Superior Board) would be established together with a new Auditing Board called *Conselho de Auditoria*. This so-called *Conselho Superior* would be exclusively composed by shareholders and would have a wide range of supervising and managing powers, although it would not be involved in the daily management of the company (the day to day management would be carried out by the Executive Committee and the Board of Directors).

The Superior Board (*Conselho Superior*) is similar to the Advisory Board (*Conselho Geral*) of the two-tier system of the Portuguese Companies Code, since they have similar functions and powers and are both composed by shareholders.

These governance improvements also reflect the trend to import features from the Anglo-Saxon governance model, such as remuneration and nomination committees. The implementation on the governance structure of some companies, of a typical “Audit Committee” composed by directors, a so-called *Conselho de Auditoria* (which can be freely translated as Audit Board), which is different from the Portuguese *Conselho Fiscal* (commonly also translated as Audit Committee) in its composition and powers from the Anglo-Saxon concept, reflects to large extent this trend.

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