Recommendations on Corporate Governance

Introduction

The development of securities markets has led to intense debate on the structure and control of public companies. By no means a new problem, it has generally been categorised as an issue relating to corporate governance. Furthermore, with respect to the universal question of how to improve mechanisms designed to protect investors, the aforementioned topic has extended to all international markets.

The term "corporate governance" refers to the system of rules and codes of conduct relating to the direction and control companies issuing shares admitted to trading on a regulated market. This analysis of corporate governance *is not designed to impose rigid and uniform models*. It is rather aimed at contributing to the optimum development of companies and at protecting the interests of all those who are involved in these companies - namely investors, creditors and workers.

Corporate governance has both an *internal* aspect and an *external* one: internal in the sense that it implies the application of sets of organisational rules within each listed company, and external in that it relates to the evaluation of the general performance of companies based on the normal functioning of market mechanisms, something for which the participation of institutional investors is of the utmost importance.

The internationalisation of companies has made the standardisation of security and organisational parameters of agents involved in the markets even more important. Thus, *in view of the globalisation of markets and the impact of the introduction of the euro, this problem can no longer be ignored in Portugal*.

In this respect, based on the conviction that the national legal system is already equipped with solutions which, in spite of not having been specifically designed for the purpose in question, adequately address problems associated with the matter of corporate governance, the present document aims to deal with the matter in a national context, through the presentation of a series of recommendations.

By endeavouring to reflect upon the matter of corporate governance in Portugal in a critical fashion, these recommendations represent not only the lowest common denominator for the matter in question, but also a range of indicators adapted both to the Portuguese legal system and to Portugal's markets.

Although companies issuing shares admitted to trading on a regulated market and institutional investors lie at the heart of this problem, these recommendations may, naturally, also be adopted by companies whose shares are not admitted to trading on a regulated market.

As this document comprises a set of recommendations, an assessment of its acceptance, to be carried out by the securities market, is essential. After all, the market itself is in the best position to evaluate the readiness of listed companies and institutional investors to adopt recommended governance strategies and options.

Thus, CMVM Regulation Nº 07/2001 obliges companies issuing shares admitted to trading on a regulated market to divulge annual information on various aspects of corporate governance in an appendix to their annual management report. Of particular importance is information related to the level and means of adoption of the present recommendations.

These recommendations are intended to be regarded as recommendations *by* and *for* the market. Therefore, the CMVM continues to be open to suggestions and opinions on the document in question, for which reason the recommendations in question are subject to revision and additions.

I – DISCLOSURE OF INFORMATION

1. The use of new information technology resources is encouraged with respect to the disclosure of financial information and of preparatory documents for General Meetings.

The use of new information technology resources, such as the Internet, may facilitate the preparation of General Meetings, favouring a rationalisation of the costs and time involved. New technologies are, therefore, not only an instrument for the modernisation of companies with shares admitted to trading on a regulated market, but also a requirement arising from the globalisation of markets.

2. Each listed company is required to ensure the appointment of a permanent representative for liaison with the market, respecting the principal of equality among shareholders and preventing uneven access to information on the part of investors. The creation of a department designed to assist investors is therefore recommended.

The setting up of a department for investor assistance is by now a common practice in the Portuguese capital markets, and is to be encouraged, insofar as it provides a centralised forum for questions posed by investors and for any subsequent clarifications deemed appropriate and disclosed to the markets.

II - THE EXERCISING OF VOTING AND REPRESENTATION RIGHTS BY SHAREHOLDERS

3. The active exercising of voting rights, whether directly, by post or by proxy, is to be encouraged.

The generic regulations set out in Portugal's Commercial Company Code (Código das Sociedades Comerciais) on the exercising of voting rights allow companies to develop measures in their own statutes aimed at combating the level of absenteeism among shareholders at General Meetings. In light of this philosophy, the new Portuguese Securities Code (Código de Valores Mobiliários) confirms the acceptability of postal voting by shareholders in public companies at their General Meetings. The Code also develops a framework for the representation by proxy of shareholders, thus signalling legislative developments that must be accompanied by changes in practices observed at company level. Further to these developments, the CMVM drew up a set of Recommendations on Postal Voting in Public Companies

involving a series of practical advice aimed at contributing to the equitable and efficient application of the right to submit postal ballots.

4. The principles of good professional conduct and transparency, which should be observed with regard to corporate governance, stress the importance of promoting the perfection of procedures linked to requests for representation by proxy at Annual General Meetings. It is fundamental that shareholders be provided with the information they require to make the right decisions regarding the stipulation of voting instructions, and that the grounds for their choice of vote be made clear, especially in the event of a lack of instructions provided by the represented party.

Given the nature of voting by proxy, it is only natural that its acceptance gives rise to the need to ensure the availability of all information required by represented shareholders in order to allow them to make an informed decision regarding their vote, especially in cases where the decisions to be made are critical to the survival of the company or could eventually lead to conflicts of interest. The clarification by represented shareholders of the reasons behind their choice of vote is also of great importance, particularly when the represented party fails to give instructions pertaining to the vote. Article 23 of the Securities Code already safeguards the legal rights of shareholders in cases where more than five requests for representation by proxy are made. The present recommendations may only be regarded as such (and not as legally binding Regulations) in cases where the number of requests for representation by proxy is less than 5.

III – CORPORATE RULES

5. It is recommended that companies establish their own internal organizational regulations aimed, firstly, at resolving conflicts of interest between members of the board and the company, and secondly, at responding to duties related to the diligence, loyalty and confidentiality of the members of the board, particularly regarding the prevention of improper use of business opportunities and company assets.

In order to ensure the observance by companies of principles of good professional conduct, by definition universally applicable to the organization of any company, it is necessary to allow for the specific characteristics of the company in question (i.e. the dimensions of the company, shareholders, management experience etc.). In line with guidelines already established by law, namely Articles 397, 398, 428 and 437and of Nº 6 of article 410, all of the Portuguese Companies Code (Código das Sociedades Comerciais), this recommendation is intended to encourage the establishment or development of codes of conduct and internal regulations with respect to sensitive matters, such as conflicts of interests, confidentiality or diligence in the day to day management of the company.

6. It is recommended that companies establish internal control systems, aimed at efficiently detecting risks arising from the activities of the company, and thereby helping to safeguard the assets of the company and the transparency of its corporate governance strategies.

Internal control systems help the directors of companies to detect relevant risks (financial, environmental and legal, among others). The creation of a risk-rating

system (e.g. through the existence or organic units designed to carry out internal audits and/or risk management) constitutes not only a means of reducing such risks, but also of increasing the quality of information disclosed to the market. Furthermore, it provides a privileged means of guaranteeing transparency as regards corporate governance.

7. Measures adopted to prevent the success of public offerings for acquisition should respect the interests of the company and its shareholders. Measures considered contrary to these interests include defensive clauses intended to cause an automatic erosion of company assets in the event of the transfer of control, or of changes to the composition of the board which prove detrimental to the free transferability of shares and the free assessment by shareholders of the performance of members of the board.

The efficiency of the shareholder control market is based essentially on the right to transfer shares, on the unwaivable right granted to the shareholders to assess the situation of the company and on the responsibility of its leaders for the financial results obtained. These principles require a distinction to be made between benign defensive measures and those that harm the rights and expectations of shareholders and the market in general. For this reason, it is important to condemn the adoption of certain defensive measures which, in seeking at all costs to limit the success of public offerings for acquisition without the agreement of the board, end up damaging the interests of partners in the company.

IV - COMPOSITION OF THE BOARD OF DIRECTORS

8. The board should be composed of a number of members who provide managers with effective guidance for the management of the company.

It is important that the board exercises effective control over the day-to-day management of the company, reserving the sole right to make decisions on important matters. In order to pursue this objective, it should convene at regular intervals, be duly informed at all times and ensure the efficient supervision of the management of the company. In particular, procedures should be put in place to ensure the provision of all information necessary for members of the board to carry out their functions effectively.

9. The inclusion on the board of one or more members who are independent in relation to the dominant stakeholders is encouraged, with a view to maximising the pursuit of corporate interests.

The board of directors should be comprised in such a way as to ensure that the management of the company is not only geared towards the protection of the interests of majority stakeholders, but also of investors in the company (irrespective of the size of their stake) and workers alike. It is therefore recommended that independent members exercise significant influence on collective decision-making and that they contribute to the development of the strategies of the company, thereby acting in the interests of the company as a whole. To this end, it is essential that each company determine the concept of independent director which is best suited to its particular characteristics, and that the said concept is explained publicly.

10. In the event of the creation of an Executive Committee, its composition should, insofar as it is possible, reflect the balance existing on the board between independent directors and those who are linked to major stakeholders in the company. In accordance with the Principle of Transparency, the board of directors must be duly informed at all times of all matters brought before it and all decisions taken by the Executive Committee.

The creation of an Executive Committee can be a valuable tool in the management of complex corporate organisations. In order to avoid the diminishment of the influence of independent directors on corporate governance, it is recommended that the composition of the Executive Commission in question be a true reflection of the balance existing within the board of directors. Regardless of the power conferred upon boards of directors under the terms of Nº 5 of article 407 of the Portuguese Securities Code, namely that which allows them to adopt resolutions on matters delegated to their Executive Committee, and of the responsibility of boards to monitor the activities of the said Commission, it is recommended that the relations between the two bodies in question be guided by the Principle of transparency. To this end, procedures should be adopted which ensure that the board of directors of a given company is, at all times, fully aware of decisions made by its Executive Commission.

11. The board is encouraged to set up internal control committees, made up of non-executive administrators, with the power to intervene in relation to all matters which could potentially lead to conflicts of interests, such as the evaluation of corporate structure and governance.

Given that conflicts of interest are more likely to arise with relation to members of the Board of Directors which have managerial functions, in order to maximise the efficiency of internal control committees, it is recommended that such Boards be comprised of members who are not directly involved in the day-to-day running of the company. The creation of a separate committee for all areas which could lead to conflicts of interests is not necessary. Nor do the members of each committee necessarily need to be different. However, the setting up of a single committee to respond to all potential conflicts of interest is inadvisable, given that the excessive workload involved and the concentration of powers would pose a threat to the efficiency of the committee.

12. It is recommended that part of the remuneration of the members of the board, in particular of members involved in current management, depend on the results of the company.

In bridging the gap between the interests of members of the board of directors of a given company and its shareholders, such a remuneration policy would maximise the exercising of good management practices devoted to increasing the income and decreasing the expenses of the company, something from which shareholders in the company would in turn benefit.

13. It is recommended that the proposal presented at the Annual General Meeting of a given company related to the approval of plans to allot shares and/or options for the purchase of shares to members of the board and workers include all the elements required for the correct evaluation of the proposal in question. If a regulation regarding the proposal is already available, it too should accompany the proposal.

Several different types of stakeholding by members of the board and the workers of a given company in its capital (e.g. the allotment of shares at discounted rates and the creation of long-term stock option plans designed to prevent options to purchase) have, over the last few years, become an increasingly popular and common phenomenon. Considering that proposals relating to disposal of own shares depend on the authorisation of the General Assembly (Nº 1 of article 320 of the Commercial Company Code) and given the influence of these allotments, regardless of the type, on the financial situation and remuneratory policy of securities issuers, particularly as with the case of members of the board of directors, it is recommended that the proposal related to the approval of such plans, presented at the Annual General Meeting, be as complete as possible. To provide an example, without prejudice to other legal requirements, in the case of allotment of shares, and/or options, mention of the justifications for the adoption of such a plan, the category and number of people involved, the conditions governing the allotment, criteria for determining the price of the shares or stock options, the number and characteristics of the shares to be allotted, the term within which they can be traded, the incentives for purchasing the shares/stock options and the role of the board of directors in carrying out/modifying the plan, all contribute towards the presentation of a comprehensive and complete proposal.

V - INSTITUTIONAL INVESTORS

14. Institutional investors should take into consideration their responsibility to contribute to the diligent, efficient and critical use of the rights conferred on them by the securities they hold or whose management has been entrusted to them, particularly with regard to information and voting rights.

With the development of the securities markets, the significance of the independent role afforded to institutional investors (i.e. investment fund management companies, pension fund management companies and asset management companies) is clearly growing. Furthermore, empirical research has revealed that the effective management of securities by institutional investors, which is, of course, required by law, contributes in a highly positive way to the development of companies. It is therefore appropriate to stress the importance of the diligent, efficient and critical application by institutional investors of the aforementioned rights conferred on them.

15. Institutional investors should disclose all information on their exercising of the voting rights afforded to them by the securities they are called upon to manage.

It is important that the market should be easily able to assess the attitudes of institutional investors with regard to corporate governance. This is particularly the case for investment fund management companies, whose use of the rights attached to the securities that make up the assets of such funds should be transparent at all times, in particular as regards participants in the fund.