The crisis and Brazilian executive compensation

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In his inaugural address Barack Obama said that the question is not whether the market is a force for good or evil—its power to generate wealth is unmatched. But the current crisis has shown that, without adequate supervision, it may get out of control.

Between 2005 and 2007, the Brazilian capital market experienced a boom of issuance of new shares; now, however, the shares of many of the companies that issued those shares are being traded at levels that are lower than their issue prices. It is a known fact that times of economic difficulties increase the potential for top executives to draw private benefits at the expense of minority shareholders. Those benefits are granted to executive officers merely because they exert control. This phenomenon was examined earlier in connection with the Asian crisis and similar periods. The task of the regulator is to determine what measures are needed to increase transparency and to reassure investors.

The Brazilian Securities and Exchange Commission (CVM) has recently submitted for public hearing new rules relating to the registration of securities issues, which replace regulation no. 202 and which propose, among other things, more comprehensive disclosure of information related to executive remuneration.

Information on compensation will be disclosed individually, in accordance with international practice. In its presentation to the public hearing, the CVM offers three arguments it considers relevant to deciding whether this disclosure procedure must be adopted and invites opinions on its need and utility. This CVM initiative to allow the market to express its opinions on such a controversial issue is very important.

The first argument advanced by CVM is “cultural.” In other cultures, sharing information on the assets and income of highly paid individuals is accepted as a matter of course. Allegedly, in Brazil, where this culture is absent, competent individuals would lose interest in positions were they to be subject to disclosure of their compensation. A simple analogy makes it clear that this argument does not hold: the highest-paid public offices are undeniably the most sought after. No one would refuse to consider a career in the
Federal Justice Department, for instance, because he would be one of the country’s highest-paid civil servants. Why, then, apply a different reasoning to the private sector?

The second argument relates to competition with private joint stock companies, where levels of transparency are far lower and whose executives might fear disclosure of their compensation. This argument ignores the basic issue: a private joint stock company does not seek to attract resources from the savings of the general public. If an open corporation seeks those resources, it must comply with rules that allow the investor to assess executive incentives for better management.

The third argument is that of the safety of executives, which again does not hold up against an analysis of the facts. What would be more likely to attract the attention of a kidnapper: disclosure by CVM of an executive’s compensation, or an imported car parading down the street? Perhaps we should require that for their own safety executives stop using imported cars.

In times when everyone worries about possible job cuts, it is surprising that some would support the idea that making executive compensation transparent would trigger their departure from corporations. It is equally surprising that CVM should advance such simplistic arguments. The international system has yet to find a better method for identifying the executive compensation structure than disclosure of individual pay and other benefits. The latter is, by the way, an essential aspect that CVM has failed to address: What about the other benefits granted executives in addition to salary, such as bonuses or variable pay? Other laws require the disclosure of all benefits (for example, a company car) when they surpass a certain value.

Moreover, CVM asks whether disclosure of the earnings of the three highest-paid executives in a corporation would suffice, and whether personal identification would be necessary. The purpose of pay disclosure is to identify uncontrolled granting of benefits to executives at the expense of minority shareholders. In a study published by the *Journal of Finance*, Brazil has been singled out as paying the highest private benefits in the world—something that speaks for itself. Shareholders need to know how much is being paid to executives in the company so that they can understand what incentive structure they have for their actions and evaluate their performance accordingly.

CVM also asks whether seeking inspiration in the USA, where the market has a different profile, could lead to problems. A recent study I did reveals that on average the largest shareholder owns about 36% of the common shares in listed companies, which indicates—for the first time in the history of Brazil’s capital market—a substantial change in the ownership structure of traditional listed corporations. As a result, the role of management in those corporations will become increasingly decisive—and that is yet another argument in favor of more information.

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