CONTROL IN THE NEW CGOV CODE - VDA

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One of the features of recent versions of the CMVM's Code, including the last draft that has been submitted to public consultation[1] is its very broad scope. In fact, the CMVM's Code goes further beyond some classic approaches to corporate governance, such as the one set forth in the UK Corporate Governance Code, where corporate governance is about what the board of a company does and how it sets the values of the company.

The CMVM's recommendations aim at ensuring the Board and other competent bodies of the company act for the benefit of all shareholders, but also that control granted to shareholders is proportional to the capital they invested in the company.

Therefore, the Code discourages companies to adopt the so-called "control enhancing mechanisms" (CEMs), which have the effect of modifying the equation between control and capital (eg, voting ceilings and dual class of shares).

Such kind of CEMs is usually enshrined in the Articles of Association of a company, so these foundational provisions should be amended if listed companies want to comply with the Code. As Articles of Association are the result of compromises between shareholders, compliance with the Code requires that companies go through a process in order to amend bylaws that could be far from consensual.

Recently, an alternative Code of Corporate Governance, coming from the private sector (the Portuguese Institute of Corporate Governance, IPCG)[2] has adopted a completely different approach. Compliance with the Code does not require companies to amend their Articles of Association. The reason presented for this is to "ensure the easiest adaptability" to the IPCG's Code. Therefore, such Code does not put forward any recommendation on CEMs.

Theoretically speaking, setting standards that correspond to best practices of corporate governance, and leaving the option to companies either to follow them or to explain why they don't, should be independent from any reasoning on adaptability to such best practices.

Therefore, the discussion should also consider a distinct issue and answer to the question on whether the adoption of CEMs by a listed company really affects the quality of its corporate governance.

Corporate governance and freedom of contract

The European Corporate Governance Forum's working group on the question of proportionality between capital and control made a very clear statement in 2007: "Non- proportional systems do raise concerns in relation to board entrenchment, extraction of private benefits by the controlling shareholder, incontestability of control and ineffectiveness of corporate governance codes based on the 'comply or explain' approach".

Althouth pertaining to the relations between shareholders (and therefore being an expression of freedom of contract), the adoption of CEMs could increase the Board's prominence *vís-a-vís* shareholders, which is a core issue for corporate governance.

In 2007 the European Commission, after commending a study and an impact assessment, decided that there was no need for action at EU level on CEMs. However, this outcome does not prevent different options at national level.

Pyramidal groups

One should note that when a listed company is subjected to a top-down chain of control (a pyramid), the dominant shareholder benefits from a kind of CEM that is not captured by current CMVM's Code.

In fact, the recommendations are addressed to listed companies. So when the CEM is structured elsewhere at an upper level of the chain of control of the company, the recommendation simply does not apply. As a result, listed companies controlled by pyramidal groups virtually score better in official assessments against CMVM's Code than other companies that have(perhaps less effective) CEMs in place, enshrined on their Articles of Associations. This is a relevant flaw to any attempt to exorcise CEMs *via* corporate governance recommendations.

CEMs are two-sided

A non-proportional system based on the CEMs could serve several interests and purposes and have different effects on governance arrangements.

For instance, a supermajority could be useful to protect minority shareholders against the abuse of a controlling shareholder, which is definitively a crucial feature for efficient corporate governance in listed companies with tiny free floats.

However, these same CEMs could be, in different circumstances, a deterrent to takeovers, hindering the ability of the same minority shareholders to maximise the value of their shares, which also contributes to perpetuate a less-performing Board.

This diversity is not captured by discouraging CEMs in general *via* corporate governance recommendations. A company that has good reasons to adopt, for instance, a voting cap to reach a more balanced structure of control and to put in place robust mechanisms to protect minority shareholders could be pushed to non-compliance with the Corporate Governance Codes, which could be a paradox.

In summary

There are no perfect 'out of the box' solutions in this issue.

The option of leaving CEMs and Articles of Association outside the scope of corporate governance codes could be a flexible solution, giving more room to freedom of contract, but could also fall short in protecting shareholders in some circumstances that we have identified.

The opposite stance, that discourages CEMs for the sake of proportionality between capital and control could maximise shareholders return in case of takeovers and resolve some loopholes left by the former option, but has also its setbacks. For instance, it could deprive companies of useful mechanism to reach a more balanced control structure and protect minorities against abusive behaviour of the controlling shareholders.