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What is the Purpose of the State-Owned Companies Act?

Law No. 13,303, of June 30, 2016 (the "State-Owned Companies Act", or "the Act"), is one of the responses offered by Brazil's Parliament to the severe problems state-owned companies in Brazil have been facing. The combination of investments based on political criteria and systemic corruption led many such companies to a situation of near insolvency. The new legislation creates mechanisms that will supposedly prevent the recurrence of such facts.

The State-Owned Companies Act is long but to a great extent, only consolidates provisions that were previously in force; and as well as previous case law and opinions of authorities. It also states general principles with little practical effect in the short term. At best, it will support the evolution of case law, with uncertain results. Also, the Act is often unclear and imprecise – as is the case in relation to administrative sanctions which, in concrete terms, removed the possibility of applying the disbarment penalty ("inidoneidade") in bids and contracts of state-owned companies.

The most important topics and innovations brought by the Act are related to three main areas: (i) specific rules on transparency and internal integrity risks control, including the creation of independent audit committees (Articles 8, 9, 10 and 24); (ii) requirements applicable to the appointment of officers or members of the board of directors (Article 17, paragraph 1); and (iii) specific rules for bidding, with procedures other than those provided for under the general procurement legislation (Law No. 8,666, of June 21, 1993); but without the flexibility that exists under specific bidding rules of Petrobras.

The requirements applicable to directors are the ones that received most media attention. They are, nevertheless, the least relevant of all those mentioned above. The requirements instituted by the new legislation are easily meet. More importantly, the fulfillment of even the most stringent requirements does not ensure that the relevant officer is competent or ethical. Many state-owned companies officers involved in the recent corruption scandals would easily meet them. The new rules on bidding procedures, on the other hand, matter because they update, within the scope of state-owned companies, the general scheme of the general procurement legislation. However, one should not expect that innovations in the bidding procedures will lead to the actual reduction of risks associated with corruption.

As for the rules on transparency and internal controls, they can be an important factor for the establishment of internal structures capable of detecting illegal conduct. However, it is possible to meet the new requirements without achieving the expected results. Many state-owned companies already meet the standards set by the new legislation. Effective internal controls of risk and integrity obviously require more than declarations of principles and formal rules. It depends on the adoption of effective risk monitoring procedures, reporting channels and independent investigations. Those measures depend on the commitment of companies' top management.

Institutions should be designed considering the building of incentives for people to act in the desired way – and not based on the assumption that people will act straightly. This perception is missing in the State-Owned Companies Act. Alongside the newly created requirements, which can end up raising the red tape without real benefits, it is necessary to institute incentives capable of inhibiting the companies' top management from acting on their own personal interest, or on the interest of a political group. In order to achieve that, the risk of detection of illegal behaviors must be amplified, beyond integrity program whose effectiveness depends largely on the commitment and attitude of members of the same organization which should be controlled.

The leniency and plea bargain agreement programs already provided for under current legislation increase this risk, but only to a limited extent, in that they predicated upon the effectiveness of the control authorities. They are not as effective as anticartel leniency programs, which inspired such instruments in Brazil. In the case of cartels, the destabilizing

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effect of leniency programs tends to be greater than in a corruption case, because the decision to break the cartel rules and cooperate with the authority tends to benefit the company beyond the mitigation of penalties.

Cartel participants have incentives to deviate from the combined behavior, as it may allow higher sales and increase market share. What prevents the instability of the cartel is the prospect of punishment by the other members. But if a participant chooses to betray the cartel and apply for leniency, the conduct will be interrupted, thus preventing retaliation. The same dynamics and incentive structure does not necessarily occur in corruption cases; this reduces the effectiveness of leniency programs. There is no obvious benefit associated with the denunciation of participants in case of corruption, other than the mitigation of sanctions.

One way to increase the risk of detection is to consider incentives to report illegal acts to people who have knowledge of the conduct, but which did not take part in it. Employees of state-owned companies or its suppliers may have knowledge of illegal conduct, but do not necessarily have the decision-making power to prevent it and do not have the additional incentives to report it, other than their personal ethical sense. This may not be sufficient when compared to the risk of losing a job or a contract, or being perceived as a traitor. Hence, incentives must be amplified.

It is necessary to establish mechanisms which minimizes the risk of retaliation and, also, entails concrete benefits to those who report illegal acts. Not only should the reporting participant benefit from reduced sanctions; those who do not participate in the conduct but face risks associated with reporting it should also enjoy benefits, such as receiving part of the sanction imposed by the authority. By turning every individual in the company's structure a potential auditor , the risks of detection of illegal conducts increase.

The State-Owned Companies Act is an attempt at experimentation in response to problems which die hard in Brazil's business environment. Although laudable, it is not sufficiently bold.

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