

CASE STUDY 8

STATE OWNED ENTERPRISES

SOE Reforms in Brazil following “Lava Jato”

Increasing integrity in Brazil’s state-owned enterprises following the “Lava Jato” corruption investigations

Introduction

In 2014, Brazil’s *Operação Lava Jato* (Portuguese for “Operation Car Wash”) exposed one of the largest corruption scandals in the world and resulted in the largest corruption investigation by the Federal Police in Brazil’s history. Operation Car Wash, which started as an investigation into money laundering, eventually uncovered corruption in contracts worth billions of dollars that had been awarded to construction companies across Brazil. One of the worst offenders was Odebrecht, the largest construction conglomerate in South America.³⁸ Investigations centered on contracts with state-owned enterprise (SOE) Petrobras, the Brazilian Petroleum Corporation, but later revealed that corruption was embedded in virtually all public investment contracts in Brazil. Investigators implicated high-level politicians in Brazil and at least 11 other countries in Latin America and beyond (see Box 3.3: The Impact of Operation Car Wash across Latin America).

The multi-billion-dollar corruption scheme at Petrobras was intricately woven into the fabric of Brazil’s political parties and dated back to at least 1985, when Brazil transitioned to democratic rule. Board and executive appointments at Petrobras rested in the hands of political parties that formed coalition governments.

These coalition governments appointed intermediaries as directors of Petrobras and tasked them with ensuring a flow of funding back to their respective parties and allies. Political leaders achieved this through systematic bid rigging, involving a cartel of all the major construction companies, to pass funds to the intermediaries in order to finance their parties and in most cases their own personal wealth. Investigators also accused external independent auditors of aiding Petrobras in misrepresenting its business and financial operations.

Though Brazil’s largest SOEs may have appeared to have sufficient standards in place for corporate governance (e.g., listings on foreign stock exchanges), the unprecedented actions taken by the justice system forced into the public view the gaps in law, as well as the previous lack of enforcement. Following the revelations, civil society demanded radical change, with particular focus on strengthening the governance of SOEs. Robust corporate governance, therefore, was regarded as an antidote to corporate-level corruption by promoting transparency and better grounds for accountability.³⁹ A new Anti-Corruption and Money Laundering Strategy is proposing concerted action on multiple fronts to mitigate corruption risks going forward (See Box 3.4: Brazil’s National Strategy Against Corruption and Money Laundering, ENCCLA).

BOX 3.3

The Impact of Operation Car Wash across Latin America

At their core, the crimes in the Lava Jato cases are connected to public investment contracts involving the main construction groups in Brazil, as well as financing by the Brazilian Development Bank. Among these companies, Petrobras was the most deeply implicated. The company had essentially been used as a slush fund by all politicians and officials to enrich themselves and to finance their political campaigns and gain influence at home and abroad.

Investigations into the Lava Jato scandal have led to prison sentences for top executives and politicians. According to the Public Prosecutor's office, by October 2018, Lava Jato had resulted in more than 200 convictions, including corruption, abuse of the international financial system, drug trafficking, and money laundering. More than a dozen other corporations and multiple foreign leaders have also been implicated in Lava Jato, mainly through Odebrecht, which used the Brazilian system of bribing politicians of many parties, to maintain a patronage relationship. Those caught up in the corruption include Venezuelan President Nicolas Maduro and four former Peruvian presidents as well as the leader of a Peruvian political party (Keiko Fujimori).

The financial losses to Petrobras were huge. Petrobras itself estimated in its 2015 financial report that USD2.1 billion had been paid in bribes. In addition, it proposed almost USD17 billion in write-downs due to fraud and overvalued assets (including wasted investments, which nevertheless produced resources for political financing) which the company characterized as a "conservative" estimate.⁴⁰ Due in part to the impact of the scandal, as well as to its high debt burden and the low price of oil, Petrobras was also forced to cut capital investments and announced it would sell USD13.7 billion in assets over the following two years.⁴¹ By mid-2018, the corruption scandal was believed to have erased more than USD250 billion from Petrobras's market value. The oil giant has also lost billions more in legal settlements and other costs related to graft, including a USD853 million settlement with the U.S. Department of Justice, the Securities and Exchange Commission, and Brazilian authorities. Petrobras appears to be now recovering modestly as its share price recovered from a low of USD3.8 in 2016 to over USD15 as of November 2019.

Provisions in the new SOE framework to promote transparency and corporate governance

The Operation Car Wash investigation exposed many systemic problems in the governance of Brazil's SOEs. For example, it revealed the complexity of Brazilian SOE ownership arrangements, with a multitude of institutions involved in SOE reporting and oversight leading to information asymmetry and diffuse accountability relationships. In addition, state and local governments' reliance on a corrupt system of party financing meant that traditional accountability mechanisms were not

effective constraints to corruption and rent extraction.

In 2015, the Ministry of Transparency, Monitoring and Control (MTMC) prepared a Guide for the Establishment of Integrity Programs in State Owned Enterprises. The guide recommended that companies prepare their own integrity risk assessments and, on this basis, prepare their own integrity programs. The guide provided ideas and suggested measures to strengthen integrity in SOEs, including in the area of procurement through measures such as rotation of purchasing personnel.

In 2016, the government passed the Law on the Responsibility of Federal State Companies, which aimed to strengthen the internal control environment in SOEs through the introduction of fiscal councils and internal

BOX 3.4

Brazil's National Strategy against Corruption and Money Laundering (ENCCLA)⁴²

Expected results under the new Strategy:⁴³

- Development of the National Network of Money Laundering Laboratories (Red-LAB) and development of the Bank Transfer System (SIMBA), the standardization of layout for judicial decision involving bank secrecy;
- Development of the Account Register of National Financial System (CCS) and the initiative to regulate the declaration of assets and values of civil servants;
- Regulation of access by supervisory bodies to the accounting records of entities contracted by the public administration;
- Improvement of border control procedures;
- Proposals for rules to regulate the utilization of cash and cryptocurrencies in order to prevent money laundering;
- Development of the National System of Seized Goods (SNBA), administered by the National Council of Justice (CNJ) and the promotion of early disposal of assets, resulting in the improvement of the institute, later modified by Law 12,683 /12 and Law 12,694/12;
- Discussion and draft of the text of Law No. 13.810 of 03/08/2019 providing for the enforcement of sanctions imposed by United Nations Security Council resolutions, including the unavailability of assets of individuals and legal entities, and the national designation of persons investigated or charged with terrorism, its financing or related acts;
- Elaboration of a booklet for the guidance of public procurement officials (based on problems already identified by ENCCLA institutions);
- Discussion and debate about whistleblowing and production of a draft law for its regulation; and
- Recommendation for the establishment of specialized financial crime units in the Federal Police.

audit committees. The law also aimed to increase transparency around contracting and procurement, which was the main channel of kickbacks exposed by Operation Car Wash. Its implementation will be key, but the proposed instruments can be considered good practices by SOE practitioners and policy makers in the region and beyond.⁴⁴

Since 2016, SOEs in Brazil are required to establish an internal audit function which reports directly to the board and the audit committee. SOEs' internal audit function, including the nomination and dismissal of the head of the internal audit unit, is supervised by the MTMC. The state audit office undertakes financial, operational and investigative audits of SOEs. The MTMC published

guidance to support SOEs in implementing internal integrity programs. The Commission of Inter-sectoral Corporate Governance and Property Administration (CGPAR) approved a Resolution to require that all SOEs have an audit committee that reports to the board.

All SOEs must also have a Fiscal Council, a governance body that monitors management's activities and financial statements and reports to shareholders. The head of the internal audit unit may report directly to the Council on the implementation of aspects raised in the reports and by the Council.

Under the Access to Information Law (Law 12527/2011) and Decree 7724, public institutions—including

SOEs—are required to disclose information such as their internal hierarchy and structure and public procurement processes. This legislation also requires SOEs and other public institutions to establish channels for receiving information requests from the public, which shall be treated and responded to within the timeframe indicated in that law.⁴⁵

The implementation process

Introducing codes of conduct

After the law passed, all SOEs had to develop their own internal code of conduct or code of ethics, outlining in detail the expected behavior of staff and senior management, including clearly outlining what is acceptable and what might constitute conflict of interest or illegal activities. All federal SOEs had prepared and published their code of conduct as of end-2018.

Establishing statutory audit committees

The new law required that all companies establish “statutory audit committees” which would be responsible for hiring and overseeing both internal and external auditors. In addition, the committees would be responsible for receiving anonymous reports of any practices that violate the company’s business and ethical guidelines. The government expects the audit committees to strengthen internal controls and the ability of company boards to uncover and prevent corruption.

Just over 70 percent of federal SOEs had audit committees in place by early 2018 and nearly 90 percent had a whistleblower mechanism in place.

The requirement of audit committees is an overdue development for the larger SOEs, especially listed ones. Brazil has traditionally used a system of “fiscal councils” (conselho fiscal) as an equivalent to an audit committee, which had proved to be not very effective.

Revising the process for appointing board members and senior management

The new law introduced clearer requirements with regard to technical qualifications and professional

experience for appointing senior SOE management or board members. In addition, the law prohibited civil servants from holding such positions.

Increasing transparency in the procurement process

SOEs continue to be exempt from public procurement rules, but the new law imposed further restrictions on direct procurement and also required increased transparency with regard to the costing of bids and any contract amendments. Item costs (sometimes estimates) will be published while the overall financial bids remain confidential. SOEs can negotiate with potential suppliers before bids are awarded.

Monitoring and enforcement

The 2016 law is a late acknowledgement that this area had to be strengthened, according to best practices already in place in many other countries. Another development to underscore is the role of the Supreme Audit Institution (SAI)—“Tribunal de Contas da Uniao” in pursuing the corruption scheme.

The stricter controls requirements introduced in 2016 will not be enough. The changes in legislation call for active enforcement and monitoring in order to ensure effective application of the law. This means that the SAI and the state internal audit arm (the Office of the Comptroller General) will have to play an active role in order to advance the anti-corruption agenda beyond the corporate governance measures taken at the SOE-level.

Reflections

The lessons from Brazil’s SOEs can be looked at from two perspectives: (1) the actions that initially exposed the corruption and punished it, and (2) the actions that have been taken since to reduce the risk of future corruption in SOEs.

First, the actions that were exposed by Lava Jato should be viewed against the backdrop of the system of political financing. Brazilian legislation provided sitting cabinet members and other federal elected officials with special standing as they could only be tried by the



Federal Supreme Court. Cases against politicians move slowly through the court system. De facto, politicians enjoyed “practical immunity from prosecution” in the words of Matthew M. Taylor.

For a few years, reform of criminal justice and the criminal procedural code and strengthening the justice institutions led to and facilitated the investigation that disclosed the scandals. In particular, the Government of President Dilma Rousseff promoted two key laws in 2013, which allowed reduced sentences for individuals and corporations engaged in criminal activity if they denounced others and produced evidence to support the allegations. This, combined with years of capacity building and training in the justice and police sector (particularly in the pursuit of money laundering), allowed the judiciary and the police to unravel corrupt networks, which had been impossible previously.

Some of the specifics that were essential to exposing the corruption included:

- The creation of task forces by the police and federal prosecutors to concentrate effort and resources on the investigation and to prosecute serious bribery and money laundering crimes;
- The use of pretrial detentions only in cases in which there was strong evidence of the crimes or in which detentions would prevent new crimes from being committed;
- The use of plea agreements to disrupt complicity and secrecy between criminals and to advance investigations;
- Extensive international cooperation and support from Switzerland, US, and other countries;
- Trying cases under public scrutiny, from evidence and arguments to judgments;
- Speedy criminal procedures and trials; and
- Strong public backing to prevent attempts by powerful defendants to obstruct justice.

The second lens that is important is what the Operation Car Wash investigations triggered as a response. As noted above, the Brazilian government responded with legislation to improve the integrity of SOEs and align Brazil with international best practices on corporate

governance.⁴⁶ The government and the legislature in Brazil provided a robust technical response to an unprecedented crisis by adopting a comprehensive legal framework for procurement in SOEs, filling in a significant gap, and bringing innovations to the way SOEs procure goods. However, it is not clear to what extent the 2016 law alone can have the desired impact, as the root problem is a combination of private sector collusion with public sector extortion to finance the political system. Implementation of the laws is at a critical juncture and will determine their final impact. The story line so far is complex and still evolving. Civil society will undoubtedly be watching closely.

Brazil is a signatory to the OECD Anti-Bribery Convention, which establishes punishments for individuals and companies bribing public officials from other countries in order to gain an advantage in international transactions. As part of Brazil’s commitment under the working group, the country undergoes regular evaluations/assessments of its overall legal and institutional framework to combat corruption.

The OECD working group on corruption expressed concern that there is a slowdown and/or reversal in the fight against corruption in Brazil. Specifically, the Brazilian Senate has approved a Bill on Abuse of Power, which includes an overly broad definition of the offense of abuse of authority by judges and prosecutors.

Some critics argue that this new law could serve as a mechanism for corrupt individuals to unfairly attack justice-seeking prosecutors and judges for appropriately doing their jobs and have a significant chilling effect on anti-corruption prosecutions and investigations in Brazil and beyond. The new law was prepared in response to concerns about abuse within the judiciary, prompting a backlash against the recent anti-corruption drive, which some see as politically driven.

In mid-November 2019, the Brazilian Supreme Court ruled to end the mandatory imprisonment of people convicted of crimes who are appealing their cases. The decision of the Supreme Court to halt investigations and criminal proceedings based on reports from administrative agencies, including financial intelligence units, tax authorities, etc., caused some concern, as this would restrict the ability of such agencies to investigate corruption-related offenses.