Latin America and the Caribbean
Technical Department

Regional Studies Program

Report No. 39c

BRAZIL: SECURITIES PORTFOLIO AND INVESTMENT FUND REGULATION

by

Fernando J. Prado Ferreira

October 1996

Papers in this series are not formal publications of the World Bank. They present preliminary and unpolished results of country analysis or research that is circulated to encourage discussion and comment; any citation and the use of this paper should take account of its provisional character. The findings, interpretations, and conclusions expressed in this paper are entirely those of the author(s) and should not be attributed in any manner to the World Bank, its affiliated organizations, members of its Board of Executive Directors or the countries they represent.
Paucity of savings has been recognized as an important constraint limiting the growth and employment opportunities in most Latin American economies. While shortcomings in macroeconomic management are a principal cause, the underdevelopment of financial markets, products, and intermediaries can also raise intermediation costs and deprive savers of appropriate vehicles for savings.

Mutual funds constitute an important savings product and class of financial intermediary. Mutual funds provide small savers opportunities for risk diversification, professional investment management, and access to wholesale transaction costs. They significantly expand the investment opportunities available to small investors who are otherwise restricted to bank products or undiversified stock investments. They can simultaneously offer investors liquidity and foster long term regular saving habit.

While mutual funds are an enormous industry in developed countries, particularly in the U.S.A., they are still an emerging industry in most of Latin America. Only Brazil, Mexico, and Chile have significant mutual fund activity within their borders. The purpose of this series of papers is to make available better information about mutual fund regulation and operations in several Latin American countries, with a view to facilitate a comparison and improvement in their regulation and management.

This paper is part of a series of eight papers. The series is edited by Hemant Shah, Laura Mecagni, and Mike Lubrano, all from Latin America and the Caribbean Region of the World Bank. Papers are written by legal and mutual fund industry experts from Argentina (Steven T. Darch, Bernardo E. Duggan, Leonardo F. Fernández, and Andrew Powell), Brazil (Fernando J. Prado Ferreira), Chile (Santiago Edwards M., Alberto Eguiguren), Colombia (Rodrigo Puyo Vasco), Mexico (Teófilo G. Berdeja Prieto and Agustin Berdeja Prieto), and Peru (Fernando Bellido). Their time and contributions, and the cooperation of their respective institutions, are deeply appreciated.

Sri-Ram Aiyer
Director
Technical Department
Latin America and the Caribbean Region
ABSTRACT

This paper has been published as part of a series of papers on mutual fund regulations in six Latin American countries: Argentina, Brazil, Chile, Colombia, Mexico, and Peru. This paper describes the regulations governing investment vehicles of Brazil including mutual investment funds and managed portfolios. This paper is divided into two main sections. The first section describes the basic characteristics of investment funds and portfolios. The second section lists and describes the structures and investment guidelines for a variety of existing fund types for both local and foreign investors. The final section briefly describes the regulations.
CONTENTS

1. INTRODUCTION.................................................................................................................. 1

2. BASIC CHARACTERISTICS OF INVESTMENT FUNDS AND PORTFOLIOS 1
   a) The Condominium as a Legal Structure for Investment Funds.................................................. 1
   b) Managed Portfolios.............................................................................................................. 3
   c) Portfolio and Fund Management and Advisory Services ......................................................... 3
   d) Custody of the Securities...................................................................................................... 7

3. FOREIGN CAPITAL INVESTMENT FUNDS AND PORTFOLIOS.................... 8
   a) Limitations on Type of Investor ................................................................................................. 8
   b) Limitations on Type of Investment ............................................................................................ 8

4. DESCRIPTION OF INVESTMENT VEHICLES FOR DOMESTIC CAPITAL: FUNDS AND PORTFOLIOS.................... 9
   a) Financial Investment Fund (FIF) ................................................................................................. 9
   b) Financial Investment Fund - Short Term.................................................................................. 10
   c) Investment Fund in FIF Shares............................................................................................... 10
   d) Mutual Share Investment Funds.............................................................................................. 11
   e) Mutual Funds for Investment in Free Portfolio (Carteira Livre).................................................. 11
   f) Fund for Investment in Quotas of the Mutual Share Investment Fund...................................... 12
   g) Mutual Share Fund with Incentives......................................................................................... 13
   h) Sectorial Share Investment Fund............................................................................................ 13
   i) Mutual Privatization Fund - Collateralized Debt.................................................................... 14
j) Financial Investment Fund - State and/or Municipal Debt
Instrument ................................................................. 14

k) Fixed-Income Mutual Funds with Investments in Rural Industrial and
Commercial Credit Certificates ..................................... 15

l) Foreign Investment Fund for Brazilian Investors .................. 15

m) Investment Fund in Emerging Companies .......................... 15

n) Culture Investment Fund ................................................ 16

o) Real Estate Investment Fund ............................................ 16

5. DESCRIPTION OF FOREIGN CAPITAL VEHICLES: FUNDS,
PORTFOLIOS AND INVESTMENT COMPANIES ..................... 17

a) Investment Company-Foreign Capital: Annex I ................... 17

b) Investment Fund - Foreign Capital: Annex II ..................... 17

c) Securities Portfolio: Annex III ............................................ 18

d) Foreign Institutional Investors Portfolio: Annex IV .............. 19

e) Foreign Capital Fixed-Income Investment Funds ................. 20

f) Conversion Funds .............................................................. 20

g) Foreign Capital Privatization Funds .................................. 21

6. GENERAL COMMENTS ..................................................... 22
1. INTRODUCTION

Brazil has a variety of investment vehicles for both national and foreign investors interested in the Brazilian securities markets. Even though such vehicles may vary according to their objectives, there are certain important characteristics which are common to many of the mutual investment funds (hereinafter the "fund" or "funds") and managed portfolios (hereinafter the "portfolio" or "portfolios").

The purpose of this article is to set out a basic description of the mechanisms and vehicles currently available, in the following manner: (a) discussion and analysis of the main common characteristics of the funds and portfolios; (b) description of the existing vehicles for both local and foreign investors; and (c) general comments.

2. BASIC CHARACTERISTICS OF INVESTMENT FUNDS AND PORTFOLIOS

a) The Condominium as a Legal Structure For Investment Funds

Domestic investment funds are organized as condominiums, which are unincorporated entities through which joint ownership is exercised. This concept has prevailed and many of the more recently created vehicles for foreign investors are also organized as condominiums.

Under Brazilian law, a condominium can be defined as a type of entity in which two or more persons hold joint title to certain assets, each holder (the condômino or co-owner) being attributed a proportional part of such assets. The condominium has no legal identity apart from that of its owners.
The basic legal precepts governing condominiums are established in the Brazilian Civil Code, which was enacted in 1916. The structure provided for under the Code has been substantially expanded by subsequent legislation and governmental regulation, in order to permit the use of condominiums for several different activities, such as joint ownership of common areas of residential and commercial buildings, and securities.

The structure of condominiums for funds was expressly provided for under articles 49 and 50 of Law No. 4,728 of July 14, 1965, as amended (known as the "Capital Markets Law") and further regulated by Resolution No. 1280 of March 23, 1987, as amended.

The Central Bank regulations affecting condominium funds basically follow the parameters established in Resolution 1280/87, which defines a condominium as a "communion of moneys for investments in equity and debt securities". The creation of a condominium fund aimed at investments in equity securities requires that the document which verifies its formation (Instrument of Organization and regulamento) be approved by the Brazilian Securities Commission (Comissão de Valores Mobiliários, CVM). In the case of domestic funds and fixed-income funds: foreign capital, the Central Bank must be informed and a copy of the regulamento must be provided. The Central Bank or CVM authorities may deny approval based on noncompliance of the regulamento vis-à-vis applicable laws.

The regulamento of the condominium fund must be registered with the local registry of deeds and documents, and must mention the rules to which it is subject. These rules, in practice, are equivalent to a company's bylaws, and regulate the co-owners' relationship in the condominium as well as the operation and management of the entity.

Even though the condominium does not have a legal identity under Brazilian law, orders for the purchase and sale of securities are carried out in its name. Earnings from investments made by a condominium fund are subject to income tax withholdings. For this purpose, a condominium fund is registered with the General Taxpayers' Register of the Ministry of Finance as if it were a corporation.

The condominium fund will also have its own accounting records, which will be kept by the local manager. The authorities hold the manager liable for the obligations of a condominium fund pursuant to applicable law.

The rights of the co-owners in the condominium fund are represented by quotas (or shares), which correspond to a proportional amount (fração ideal) of the assets held in joint ownership. Such shares can be evidenced by investment certificates. The number of shares held by each co-owner will correspond to the amount invested in the condominium fund. In general terms, such shares can be redeemed by the fund or sold to a third party, although current regulations permit the insertion of restrictions on the sale of the shares in the rules of the condominium.

Funds and portfolios are not permitted to be leveraged and may not extend loans, grant guarantees or issue debt or equity securities of their own.
The co-owners are jointly liable for the actions of the manager of the condominium fund, provided such acts are performed in accordance with the powers effectively granted by the co-owners. Should the manager perform acts beyond his vested powers, or against the regulamento of the fund or against the law, he may be held liable.

Generally condominium funds will be considered “open condominiums” if they enable the shareholders to redeem their shares for cash and to freely assign and transfer such shares to third parties, as opposed to “closed condominiums” which among other restrictions do not allow redemption of shares for cash, except in the case of liquidation of the fund. The distribution of income is based on the regulamento of the fund, but may occur at the time of redemption of shares for cash.

Changes in investment policy (within the boundaries of applicable law) as well as substitution of managers or other decisions affecting the condominium funds may be subject to the approval of co-owners gathered at a general meeting, in accordance with the terms of the corresponding regulamento.

b) Managed Portfolios

Managed portfolios were designed as a vehicle for foreign institutional investors that wish to purchase and sell equity securities traded on the Brazilian stock exchanges. They consist of securities portfolios held in Brazil by foreign legal or Brazilian individuals, mutual funds or other collective investment entities.

In order for a managed portfolio to be authorized to purchase and sell securities, it must be previously authorized by CVM. The applicant must be an institutional investor, and may be authorized to operate portfolios on its own account or on the account of other institutional investors (known as the omnibus or collective account), also approved by CVM.

c) Portfolio and Fund Management and Advisory Services

Law No. 6385 of December 7, 1976, which created the CVM, also delegates authority to CVM to establish the rules and regulations governing the activities of securities analysts (analysts), investment advisers (advisers), and investment managers (mangers) in Brazil.

Under Brazilian law and doctrine, analysts are professional individuals engaged in the study of securities traded in the marketplace, with the sole purpose of preparing technical reports. As such, the analysts do not participate in investment decision-making activities, and are normally employed by corporations that participate in the market.

Advisers, known in Brazil as Conselheiros de Investimentos, are either individuals or legal entities that render investment recommendations and formulate investment policies for clients. The advisers’ activity is regulated by CVM Instruction No. 43 of March 5, 1985. Advisers must comply with the requirements applicable to directors and officers of financial institutions, as set forth in
Central Bank Resolution No. 1763, of October 31, 1985, as amended. In other words, the applicant must have an unblemished reputation plus experience in the securities market.

The application process for advisers is regulated by Central Bank Circular No. 1958 of May 10, 1991, as amended, which includes a specific form that must be filed by the applicant.

For purposes of funds and portfolios, managers (known in Brazil as Administradores de Valores Mobiliários), are individuals or legal entities to which investors grant powers for the purchase and sale of securities.

The managers' activities are regulated by CVM Instruction No. 82 of September 19, 1988. Because these professionals handle third-party funds for compensation, they are subject to more stringent regulations and are required to:

(i) in the case of a legal entity:

(a) be authorized in its articles of association to conduct investment management business;
(b) have the management of its clients' portfolio in the care of a director or managing partner who has previously obtained from CVM authorization as an individual manager; and
(c) maintain a technical department specialized in the analysis of the securities market under the direct responsibility of the director or managing partner referred to below.

(ii) in the case of an individual:

(a) be domiciled in Brazil;
(b) have at least three years of professional experience in the financial markets as a manager of third-party funds;
(c) have at least five years of professional experience directly related to the securities market;
(d) have a graduate degree from an institution recognized in Brazil or abroad, or undergraduate degree related to the financial markets;
(e) not have been barred from acting as director or officer of institutions which require Central Bank of Brazil's authorization to operate;
(f) not have been considered guilty in any CVM proceeding; and
(g) submit statements confirming the above.

Brazilian managers are therefore subject to CVM regulations and surveillance. Experience shows that CVM performs only limited monitoring activities, unless they have reason to believe that the managers are performing illegal or fraudulent activities, in which case they may actively investigate the managers.
The restrictions applicable to Brazilian managers are set forth in Article 11 of CVM Instruction No. 82/88, which sets forth that the manager should not:

(i) act directly or indirectly as participant in transactions with portfolios under his management, except in the case of portfolios held by individuals and if authorized in writing by such investor;

(ii) act for clients if the participant is his/her husband/wife, parent, descendant, and relative to the fourth degree, or with directors or managers of companies affiliated to the managers;

(iii) render services or perform functions different from the usual, except with the client's prior written consent;

(iv) assure rates of return, based on previous performance;

(v) promise rates of return for the portfolio;

(vi) make cash loans or advances or open credits of any kind, using funds under his/her management;

(vii) promote unnecessary securities transactions, for the main purpose of generating brokerage income for oneself or third parties;

(viii) promote transactions of any kind that will breach Brazilian law, even if beneficial for the client; and

(ix) neglect the rights and best interests of the client.

Articles 10 and 12 of CVM Instruction No. 82/88 set forth the duties applicable to the managers as fiduciaries, which are basically the following:

(i) develop their activities in a way to best serve the objectives of the client;

(ii) fulfill their obligations, as any prudent individual would under similar circumstances in their personal business affairs;

(iii) formalize by a written contract all conditions and policies of the investment management activity, specifying:

(a) the investment policy to be adopted, which should meet the client's profile and needs;

(b) the fee the managers will charge for services rendered;
(c) any other activities performed by the managers and the potential conflicts between managers' personal activities and the portfolio's management activity; and
(d) all risks inherent to the various transactions in securities on the stock exchanges, over-the-counter, futures markets, and margin account transactions which will be entered into with the investor's funds;

(iv) avoid activities that would affect the fiduciary relationship with the client;
(v) keep updated (and provide to the client upon request) all documentation related to the securities transactions of portfolios under the management of the managers, and when necessary, keep in safe custody with a CVM-approved custodian the corresponding certificates, taking all necessary steps to serve their clients' best interests; and
(vi) send to the clients on a quarterly basis:

(a) the list of securities in the portfolio and trades made in the previous quarter;
(b) brokerage and custody fees incurred by the portfolio in the previous quarter.

Further, the manager of a condominium fund must inform the co-owners regularly about the number of shares held by it, their value and rate of return and the composition of the portfolio. The publication on local newspapers of relevant information regarding the condominium fund is also required as a form of communication with co-owners and potential investors.

Financial or non-financial institutions may become accredited with the CVM to perform the activity of manager. There are no minimum capital requirements for non-financial managers. All financial institutions, however, are subject to minimum capital requirements, which vary approximately from US$ 600,000 for brokerage houses or dealerships that manage funds to US$ 10 million for multiservice banks.

The authorities have, however, entrusted the management of certain types of investment vehicles to accredited financial institutions only, based on the rule set forth in article 17 of Law 4,595, which states that only financial institutions may collect, intermediate, and invest third-party funds, subject to Central Bank monitoring. It does not seem reasonable that a duly accredited non-financial manager be excluded from eligibility to manage any type of condominium fund or portfolio.

Please note that the managers can be held liable in civil, criminal and/or administrative proceedings for acts of any kind that cause damages or breach laws or regulations, along with the clients or supervisors, should they be involved in such wrongful acts.
Foreign analysts, advisers and managers that become residents in Brazil by obtaining a permanent visa, may freely act as such in the Brazilian securities market, provided they are registered with CVM.

d) Custody of the Securities

Under Brazilian law, custodian services can only be performed by financial institutions, as permitted by Law No. 4595 of December 31, 1964, and by stock exchanges (which are not financial institutions but are rather organized as civil non-profit associations). Both financial institutions and stock exchanges need a prior authorization by CVM in order to render custody of securities services, as established by Article 24 of Law No. 6385/76 and by Article 1 of CVM Instruction No. 89 of November 8, 1988.

In practice, custodial services for equity securities traded on the Brazilian stock exchanges held by funds and portfolios are presently performed in the great majority by the São Paulo Stock Exchange and by the Caixa de Liquidação e Custódia (CLC) of the Rio de Janeiro Stock Exchange, which is linked by computer to the other exchanges of Brazil through the National Electronic Trading System. A few private banks perform custody services as well, but are increasingly eliminating such services. The understanding is that in a few years all custody services will be performed only by the stock exchanges. Custodian fees are established without the interference of the Central Bank or CVM.

In the event of liquidation of a securities custodian (extrajudicial liquidation for financial institutions or civil insolvency for stock exchanges), the securities under custody are not considered part of the custodian's assets and therefore must be returned to their respective owners. Under Article 2, Paragraph 1 of CVM Instruction No. 115 of April 11, 1990, the contract to be signed between the fund or portfolio and the custodian should be subject to prior approval by CVM, and should necessarily determine that "... the transfer to the stock exchanges of title to the securities under custody shall occur exclusively on a fiduciary basis, and the securities are therefore not considered to be part of the stock exchange's assets for any purpose". Article 13 of CVM Instruction No. 115/90 extends to financial institutions that render custodial services the same rules applicable to stock exchanges.

There are also electronic systems for registration, custody, and financial settlement of debt securities. These systems, quite similar to Euroclear or Cedel, are presently provided by Central de Custódia e de Liquidação Financeira de Títulos (CETIP), for private debt bonds, and Sistema Especial de Liquidação e de Custódia (SELIC), for public-debt bonds.

At CETIP and SELIC, transfers are made electronically, and no certificate is involved, except for issuance of the records of the account balances. Participants in the system may request the installation of teleprocessing terminals, or use the terminals of their liquidating bank.
3. FOREIGN CAPITAL INVESTMENT FUNDS AND PORTFOLIOS

There are certain limitations on foreigners purchasing and owning securities of Brazilian issuers. Such limitations can be separated into two basic categories:

a) Limitations on Type of Investor

Brazilian regulations presently provide that only those investors that operate through certain vehicles are eligible to invest on the domestic securities market. These vehicles are regulated in Annexes (I through V) to Central Bank Resolution No. 1289 issued on March 20, 1987, as follows:

Annex I - Investment companies - foreign capital;
Annex II - Investment funds - foreign capital;
Annex III - Managed portfolios of citizens or legal entities resident abroad;
Annex IV - Managed portfolios of institutional investors located abroad; and
Annex V - Depositary receipts trading of Brazilian companies.

Since the enactment of Central Bank Resolution No. 2034 and Central Bank Circular No. 2388 of December 17, 1993, as amended, foreign investors can invest in debt securities of Brazil in accordance with the rules applicable to fixed-income funds. Fixed-income funds may issue shares or units, which may only be purchased by foreign investors. The fund manager of a fixed-income fund must invest the proceeds from the sale of shares in Fixed-Income assets. The portfolio of a fixed-income fund cannot be pledged or otherwise used as collateral, loaned or leased, except in the case of margin guarantees required in connection with any futures trading on an organized market.

b) Limitations on Type of Investment

Generally, foreign investors that are admitted in Brazil by CVM through one of the above vehicles are eligible to invest in títulos e valores mobiliários - debt and equity securities of Brazilian issuers.

The communications industry has been subject to far-reaching legislation, and the acquisition or management of communications media by foreign individuals or companies is subject to certain restrictions.

Prior to 1992, the manufacture of certain informatics equipment could only be made by the so-called Brazilian companies of domestic capital (at least 51% of the voting capital held by Brazilian residents). Such barriers have been removed and Brazilian companies with domestic capital are now only granted preferential treatment in acquisition of computer goods or services by state-owned companies, or to obtain financing from state-owned banks. Brazilian companies of domestic capital are only granted tax benefits such as exemption of Tax on Manufactured Goods (IPI). However, these tax benefits can also be granted to companies held by foreigners should certain conditions established by law be observed.
Foreigners have been barred from owning and managing private companies that provide guard and valuables transport services, according to the law that regulated the organization and operation of such companies, and the safeguard of financial institutions. This prohibition does not affect these specialized companies that were already in existence on the date of publication of that law.

Companies in which the greater part of the voting capital belongs to individuals or companies’ headquartered abroad, or to the subsidiary of a foreign company, are not able to obtain a guarantee from the National Treasury or from official federal and state credit agencies (including mixed-capital companies controlled thereby) for financing obtained abroad unless they can show that they have actually started their operations. An exception is made for projects of substantial importance to the national economy which may be given a special authorization from the government. The Central Bank may deny access to funds obtained from the national financial system to companies which have access to the international market, including not only branches and subsidiaries of foreign companies, but also companies, with their principal places of business in Brazil, the capital of which belongs wholly to persons or companies resident or with their principal places of business abroad, or of which the greater part of the voting capital is held directly or indirectly by a person or company resident or headquartered abroad.

Finally, please note that foreign participation in Brazilian companies (not only on a majority basis but, in certain cases, even on a minority basis) results in certain restrictions on obtaining tax incentives.

4. DESCRIPTION OF INVESTMENT VEHICLES FOR DOMESTIC CAPITAL: FUNDS AND PORTFOLIOS

There are today many types of condominium funds and portfolios available to local investors. They basically vary according to their specific objective and eligible investments. In the following section, each of these vehicles will be briefly described.

The general rule on taxation applicable to these vehicles is that any ganho nominal (interest income and capital gains) will be subject to 15% withholding income tax, if the fund maintains at least 51% of its investments in fixed-income assets, and will be subject to 10% withholding income tax, if the fund maintains at least 51% of its investments in variable-income assets.

a) Financial Investment Fund (FIF)

i) Legal Form: Open condominium.

ii) Eligible Investments: Deposits in the Central Bank, as per specific regulation; assets and/or operational modalities available in the financial market, with the exception of promissory notes issued by joint stock companies destined to public offer, Economical Development Bonds (TDE), and shares of the Social Development Fund (FDS).

iv) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership.

v) Taxation: If the fund maintains at least 51% of its investments in fixed-income assets, any capital gains will be subject to 15% withholding income tax. If the fund maintain at least 51% of its investments in variable-income assets, any capital gains will be subject to 10% withholding income tax.

b) Financial Investment Fund - Short Term

i) Legal Form: Open condominium.

ii) Eligible Investments: At least 50%, separately or cumulatively, in bonds issued by the Brazilian Treasury and/or the Central Bank; deposits with the Central Bank, with due regard for the minimum of 25%, updated and remunerated. Bank certificates of deposit, bills of exchange, mortgage bills, bonds issued by the Brazilian Treasury and/or the Central Bank, state and municipal public debt bonds, debentures. Up to 30% of the investments may be represented by bonds included in the portfolio of institutions qualified to carry out matched transactions linked to repurchase commitments assumed by such institutions.


iv) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership.

v) Taxation: 15% withholding income tax on capital gains.

c) Investment Fund in FIF Shares

i) Legal Form: Open condominium.

ii) Eligible Investments: Shares of investment funds, with the exception of shares of fundo de investimento financeiro que não de curto prazo por parte de fundo de aplicação em shares de fundo de investimento - curto prazo, and shares of fundo de investimento financeiro com intervalo de atualização do valor da share superior àquele adotado pelo fundo de aplicação em shares de fundo de investimento.

iv) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership.

v) Taxation: If the fund maintains at least 51% of its investments in fixed-income assets, any capital gains will be subject to 15% withholding income tax. If the fund maintains at least 51% of its investments in variable-income assets, any capital gains will be subject to 10% withholding income tax.

d) Mutual Share Investment Funds

i) Legal Form: Open or closed condominium.

ii) Eligible Investments: At least 51% of the funds in shares of publicly-held companies. The remaining funds will be invested in other securities issued by publicly-held companies; certificates of deposit of shares issued by companies headquartered in MERCOSUR member countries, which may be publicly traded in Brazil; or shares in fixed-income funds and fixed-income securities chosen according to the discretion of the manager.

iii) Mutual share funds may hold positions in organized futures markets in shares or share indexes; uncovered trades (short positions) or risky transactions for the portfolio are forbidden.


v) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership.

vi) In the event the fund manager is neither a financial institution nor a member of the securities distribution system, it must retain the services below from accredited institutions:

a) opening and operation of bank accounts in the fund's name;
b) receipt of proceeds from the issuance or payment of fund shares, and payment of shares as a result of redemptions or liquidation of the fund;
c) receipt of dividends and like earnings; and
d) financial settlement of the fund's transactions.

vii) Taxation: 10% withholding income tax on capital gains.

e) Mutual Funds for Investment in Free Portfolio (Carteira Livre)

i) Legal Form: Open or closed condominium.
ii) Eligible Investments: At least 51% of the portfolio equity must be invested in shares, subscription warrants, and convertible debentures of publicly-held companies; and shares or share depositary receipts issued by companies headquartered in the Asunción Treaty - MERCOSUR signatory countries, and admitted for public trading in Brazil. The fund may hold positions on organized futures markets in shares or share indexes. The remaining equity may be invested in other securities issued by publicly-held companies and traded on stock exchanges, or on over-the-counter markets organized by an entity accredited by CVM, or otherwise acquired by way of public underwriting; shares of fixed-income funds, and fixed-income bonds, at the managing institution's discretion; and shares of closed-end mutual funds for investments in shares or in free portfolios, at least 90% of the equity of which must be composed of shares.

iii) Governing Regulations: CVM Instruction No. 215, of June 8, 1994, as amended.

iv) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership; asset management company.

v) In the event the fund manager is neither a financial institution nor a member of the securities distribution system, it must retain the services below from accredited institutions:

1. opening and operation of bank accounts in the fund's name;
2. receipt of proceeds from the issuance or payment of fund shares, and payment of shares as a result of redemptions or liquidation of the fund;
3. receipt of dividends and like earnings; and
4. financial settlement of the fund's transactions.

vi) Taxation: 10% withholding income tax on capital gains.

f) Fund for Investment in Quotas of the Mutual Share Investment Fund

i) Legal Form: Open or closed condominium.

ii) Eligible Investments: At least 95% of the funds in shares of a Mutual Share Investment Fund and a Mutual Share Investment Fund - Free portfolio. The remaining amount will be invested in shares of fixed-income funds or fixed-income securities, chosen at the discretion of the manager.

iv) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership; asset management company.

v) Taxation: 10% withholding income tax on capital gains.

g) Mutual Share Fund with Incentives

i) Legal Form: Closed condominium.

ii) Eligible Investments: Joint funds earmarked for investment in a diversified securities portfolio, with at least 70% in shares issued by companies that receive funds derived from tax incentives under Decree-laws Nos. 1376 of December 12, 1974 and 2298 of November 21, 1986, which are registered at CVM pursuant to CVM Instruction No. 92 of December 8, 1988, as amended, certificates of investments in the FINOR, FINAM, Fiset and FUNRES funds or shares acquired on the Secondary Market of Securities with incentives provided for in CVM Instruction No. 92 of December 8, 1988, as amended, or by special auctions for securities with incentives carried out on the stock exchanges. Remaining funds shall be invested in public debt securities, Central Bank of Brazil notes or bonds, shares of Financial Investment Funds and shares or debentures issued by publicly-held companies and acquired on the stock exchange or in the over-the-counter market authorized by CVM or by subscription.


iv) Management: Multiservice bank; investment bank; credit, finance and investment company; securities dealership.

v) Taxation: If the fund maintains at least 51% of its investments in fixed-income assets, any capital gains will be subject to 15% withholding income tax. If the fund maintain at least 51% of its investments in variable-income assets, any capital gains will be subject to 10% withholding income tax.

h) Sectorial Share Investment Fund

i) Legal Form: Closed condominium.

ii) Eligible Investments: equity securities of companies of specific economic sectors, investing at least 75% of their equity in shares and debentures of companies registered with CVM and pertaining to the field of activity specified in the bylaws of the fund.

iv) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership; asset management company.

v) Taxation: 10% withholding income tax on capital gains.

i) **Mutual Privatization Fund - Collateralized Debt**

i) Legal Form: Closed or open *condominium*.

ii) Eligible Investments: Exclusively in shares of privatized companies pursuant to Law No. 8,031 of April 12, 1990, debentures of companies privatized pursuant to Law No. 8,031/90, debentures of controlled or associated companies, or debentures issued by controlling companies of these companies, securities issued by a legal entity which participates as a purchaser in auctions of the Brazilian Privatization Program, with due regard for the 45% cap on the fund equity, Certificates of Privatization, outstanding Federal Government debts or debts guaranteed thereby which are canceled upon the corresponding issue of debentures by a company directly or indirectly controlled by the Federal Government, shares of Financial Investment funds, or other securities and obligations set forth in article 36 of Joint Communique No. 34 of May 9, 1991, as amended.

iii) Governing Regulations: Joint Communique No. 34 of May 9, 1991, as amended; and Joint Communique No. 42 of September 13, 1991, as amended.

iv) Management: Multiservice bank; investment bank; brokerage firm; securities dealership.

v) Taxation: 15% withholding income tax on capital gains.

j) **Financial Investment Fund - State and/or Municipal Debt Instrument**

i) Legal Form: Open *condominium*.

ii) Eligible Investments: Funds exclusively earmarked to acquire bonds issued by the corresponding state and/or municipality; up to 30% of these bonds may be represented by bonds which are part of the portfolio of the managing institution itself, and are linked to repurchase commitments assumed by such institution in matched transactions.

iv) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership.

v) Taxation: 15% withholding income tax on capital gains.

**k) Fixed-Income Mutual Funds with Investments in Rural, Industrial and Commercial Credit Certificates**

i) Legal Form: Open condominium.

ii) Eligible Investments: Rural, industrial and commercial credit certificates and federal public bonds.


iv) Management: Multiservice bank; investment bank; credit, finance and investment company; brokerage firm; securities dealership.

**l) Foreign Investment Fund for Brazilian Investors**

i) Legal Form: Open condominium.

ii) Eligible Investments: Brazilian foreign debt notes, represented by at least, 60% of National Treasury or Central Bank notes, the remaining, in other commercial papers on the international market.

iii) Governing Regulations: Decree No. 1251, of September 22, 1994; Resolution No. 2111, of September 22, 1994, as amended; Central Bank Circular No. 2485, of September 22, 1994, as amended.

iv) Management: Multiservice bank; commercial bank; investment bank; brokerage firm; securities dealership.

v) Taxation: 15% withholding income tax on capital gains.

**m) Investment Fund in Emerging Companies**

i) Legal Form: Closed condominium.

ii) Requirements: (a) The minimum amount of each share (notional share) of the fund is R$ 100,000 (approximately US$ 85,000); (b) the fund shall be organized with
a limited duration of up to ten years, with the possibility of a five-year extension; (c) prior CVM approval is necessary for the functioning of the fund.

iii) Eligible Investments: Diversified portfolio of securities issued by Brazilian "emerging companies", defined as those which have annual net income below R$ 30 million (approximately US$ 25 million), applicable for the first investment. Later on, the fund may acquire other securities of the same issuer, even if its annual net income exceeds the "emerging companies" limit.


v) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership; asset management company.

vi) Taxation: 10% withholding income tax on capital gains.

n) Culture Investment Fund

i) Legal Form: Open or closed condominium.

ii) Eligible Investments: Artistic and cultural investments, in accordance with the applicable legislation.

iii) Governing Regulations: CVM Instruction No. 186 of March 17, 1992, as amended.

iv) Management: Multiservice bank; investment bank; credit, finance and investment company; brokerage firm; securities dealership; asset management company.

v) Taxation: 10% withholding tax on capital gains and income.

o) Real Estate Investment Fund

i) Legal Form: Closed condominium.

ii) Eligible Investments: Real estate enterprises in accordance with the applicable legislation.

iv) Management: Multiservice bank; real state credit company; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership.

v) Taxation: 10% withholding tax on capital gains and income.

5. DESCRIPTION OF FOREIGN CAPITAL VEHICLES: FUNDS, PORTFOLIOS AND INVESTMENT COMPANIES

a) Investment Company - Foreign Capital: Annex I

i) Legal Form: Joint-stock company with authorized capital, previously approved by the CVM.

ii) Requirements: Initial capital must be paid in by specified types of financial institutions and later the shares must be placed with foreign investors within 180 days.

iii) Eligible Investments: Diversified portfolio of securities of Brazilian issuers and the remaining funds may remain available or invested in shares of open capital companies registered or not acquired in stock exchange or by subscription, and in other investments expressly authorized by the CVM jointly with the Central Bank of Brazil.

iv) Governing Regulations: Resolution No. 1289 of March 20, 1987; Resolution No. 1658 of October 26, 1989; Resolution No. 2246 of February 8, 1996.

v) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership.

vi) Taxation: Investment Companies are exempt from corporate income tax; capital gains earned by such companies are exempt from Brazilian income tax.

vii) Diversification Requirements: Investment Companies, as well as Investment funds and Managed portfolios which are more fully described below, are subject to restrictions as to the type of investment they can make. These restrictions were basically designed to promote diversification and, in the specific case of Investment Companies, to channel investments to minority equity participation in Brazilian-controlled publicly-held companies. The basic rules are the following: (i) 50% of the Investment Companies equity must be invested in shares issued by publicly-held companies controlled by private Brazilian capital; (ii) investments cannot exceed 5% of the voting stock, or 20% of the total shares of any given company; and (iii) no more than 10% of the equity may be invested in securities issued by one single company.

b) Investment Fund - Foreign Capital: Annex II
i) Legal Form: Open condominium.

ii) Requirements: The bylaws must be approved by CVM and shares of the fund must be placed with foreign investors.

iii) Eligible Investments: Diversified securities portfolio, and the remaining funds invested in other securities of emission of open capital companies, observed that cannot be invested in fixed-income assets, in other investments expressly authorized by CVM jointly with the Central Bank.


v) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership.

vi) Taxation: Capital gains earned by such funds are exempt from Brazilian income tax; any other income received by investment funds is subject to 15% withholding tax.

vii) Diversification Requirements: See explanation for Investment Companies (item 5.1. above).

c) Securities Portfolio: Annex III

i) Legal Form: Securities portfolio.

ii) Requirements: The foreign entity that owns the portfolio must be listed on a foreign stock exchange and must have a corporate objective that includes investments in Brazilian securities. CVM must previously approve the operations of the portfolio, which must comply with a minimum capital requirement (at this date US$ 100 million).

iii) Eligible Investments: At least 70% in shares of publicly-held companies (daily minimum of 35%) and the remaining funds in other securities of emission of open capital companies, observed that cannot be invested in fixed-income assets, in other investments expressly authorized by CVM jointly with the Central Bank.


v) Management: Multiservice bank; investment bank; brokerage firm; securities dealership.
vi) Taxation: Capital gains earned by these portfolios from their activities in Brazil are exempt from income tax; income received by Managed portfolios is subject to 15% withholding tax.

d) Foreign Institutional Investors Portfolio: Annex IV

i) Of all the existing vehicles suitable for foreign investors, Annex IV has been mostly used.

ii) Legal Form: Securities portfolio.

iii) Requirements: The foreign entity must seek approval from CVM as an eligible institutional investor, based on the tests set by CVM regulations. Further, such institutional investor must undertake:

a) Not to use the portfolio funds, directly or indirectly, either to acquire control or increase its stake in a controlled or associated Brazilian company, or further to acquire securities issued by closely-held companies;

b) not to lease, loan or pledge the securities of the portfolio or rights related thereto, except for the cases expressly authorized by CVM;

c) not to acquire or sell, in Brazil, outside stock exchange trading sessions, shares of publicly-held companies registered for trade in exchange, with due regard, as far as acquisition is concerned, for the cases of subscription, stock dividends and conversion of debentures into shares;

d) not to acquire or sell shares traded on the over-the-counter market, whether or not organized by an entity not approved by CVM;

e) not to transfer, abroad, title to the securities pertaining to the portfolio; and

f) only to dispose, abroad, of any rights pertaining to such securities in any way, such as sale, assignment, granting of participation or transfer to another eligible institutional investor, which expressly undertakes to comply and cause compliance with the provisions of the regulation, informing CVM of any transaction of this kind.

iv) Eligible Investments: There are no composition and diversification requirements for this type of portfolio, but all transactions must be with shares issued by publicly-held companies carried out on stock exchanges; the portfolio’s equity not invested in equity securities, however, may be kept available or invested in other investments expressly authorized by CVM jointly with the Central Bank.

v) Governing Regulations: Resolution No. 1289, of March 20, 1987; Resolution No. 1832, of May 31, 1991, as amended; Resolution No. 1935, of June 30, 1992, as amended; Resolution No. 2034, of December 17, 1993, as amended; Central Bank
Circular No. 2052, of October 3, 1991; CVM Instruction No. 169, of January 2, 1992; CVM Instruction No. 190, of June 25, 1992; and CVM Instruction No. 210 of April 15, 1994; Resolution No. 2246 of February 8, 1996.

vi) Management: Multiservice Bank; Commercial Bank; Investment Bank; Savings Bank; Credit, Finance and Investment Company; Brokerage Firm; Securities Dealership; Asset Management Company.

vii) Taxation: Capital gains earned by these portfolios from their activities in Brazil are exempt from income tax; income received by Annex IV portfolios is subject to 15% withholding tax.

e) Foreign Capital Fixed-Income Investment Funds

i) Legal Form: Open condominium.

ii) Requirements: (a) The creation of these funds is not conditioned to the Central Bank's prior authorization, but the Central Bank must be advised of any such creation within five days of filing of the acts of incorporation at the proper Registry of Deeds and Documents; (b) the fund name must include the expression fundo de Renda Fixa - Capital Estrangeiro (Fixed-income fund - Foreign Capital); (c) the acts of incorporation must reflect the fund's own regulations, and identify its incorporators; (d) the fund shares may be redeemed at any, but are nontransferable; (e) foreign capital must be registered in the name of investors with shares in the fund.

iii) Eligible Investments: Mainly debt securities of Brazilian corporate or government issuers.


v) Management: Multiservice Bank; Investment Bank; Brokerage Firm; Securities Dealership.

vi) Taxation: The IOF Tax (Tax on Credit, Exchange, Insurance or Securities Transactions) is collected at the rate of 7% on the Brazilian currency amount corresponding to the foreign capital inflow, upon settlement of the exchange transaction (the rate is higher due to the governmental policy of providing incentives for foreign investments in the stock exchanges rather than in debt securities); tax exemption on capital gains earned by fixed-income funds.

f) Conversion Funds

i) Legal Form: Open condominium.
ii) Requirements: (i) The bylaws must be approved by CVM and shares of the fund must be placed with foreign investors; (ii) an investment in a Conversion fund must be kept in Brazil for a minimum of twelve years; (iii) the start-up equity capital should be at least R$ 50,000 (approximately US$ 43,000).

iii) Eligible Investments: Debt/equity conversion (whether through the auction mechanism, or through conversion of private sector future maturities) in a Conversion fund.


v) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership.

vi) Taxation: Income and capital gains obtained by Conversion funds are exempt from income tax; income distributed and capital gains earned by the condominium member upon redemption of its fund shares are subject to 10% withholding tax.

g) Foreign Capital Privatization Funds

i) Legal Form: Open or closed condominium.

ii) Requirements: (a) Preliminary CVM approval is necessary; (b) the fund must use in its business name the term "Privatization fund - Foreign Capital"; (c) the fund assets may be paid in using: (i) bonds issued by the Brazilian Government under Brazilian debt restructuring agreements, and the corresponding charges; deposits made voluntarily for hedging purposes; funds on deposit at the Central Bank under the exchange centralization regulations; and/or (ii) fresh funds coming into Brazil by way of foreign investment. Payment by use of the moneys mentioned in (i) above will take place only after the privatization auction bid has been financially settled; and (d) investments made with moneys from conversion of Brazilian foreign debt instruments and credits must remain in Brazil for at least six years. This six-year lock-in period does not apply to funds paid in with fresh moneys.

iii) Eligible Investments: Exclusively in shares issued by companies being denationalized through the Brazilian Denationalization Program ("PND"), provided such shares were acquired in the privatization process and Rural Debt Bonds (TDA); Brazilian Development fund Bonds (OFND); debentures issued by SIDERBRAS; Privatization Certificates; and other credits and bonds that represent the federal government's securitized debt, and qualify for use under the PND.

v) Management: Multiservice bank; commercial bank; investment bank; savings bank; credit, finance and investment company; brokerage firm; securities dealership.

vi) Taxation: Income and capital gains obtained by Privatization funds are exempt from income tax; income distributed and capital gains earned by the condominium member upon redemption of its fund shares are subject to 15% withholding tax.

6. GENERAL COMMENTS

The eligible investments and diversification requirements for the various types of condominium funds and portfolios described above result from: (i) the monetary, exchange and tax policies of the Brazilian government; (ii) the need to direct investment to developing markets within the local financial system; and (iii) financing of the internal deficit, whenever there are mandatory investments in securities issued by governmental entities.

The Central Bank of Brazil, which is an autarquia (an autonomous government entity), administered by a board of directors with a president and five directors, all appointed by the President of the Republic, subject to approval by the Senate. The role of the Central Bank is to implement the currency and credit policies laid down by the National Monetary Council. In addition, all financial institutions are subject to control by the Central Bank.

CVM, also an autarquia, is an entity created by Law No. 6385 of December 7, 1976 with the responsibility to permanently control the activities and services of the securities market and disclose information relating to the market, individuals participating in it and the securities traded thereon. Also, CVM is the entity in charge of regulating the matters expressly provided in the Corporation Law (Law No. 6404 of December 15, 1976), with due regard for the policies defined by the National Monetary Council, as well as controlling and inspecting publicly held companies and proposing to the National Monetary Council any establishment of maximum limits for prices, commissions, fees and any others benefits charged by market brokers. Also, CVM is responsible for regulating funds which invest in equity securities.
Other Reports in the Regional Studies Program:


No. 31: Labor Market Legislation in Latin America and the Caribbean, December 1993.


No. 36: Infrastructure and Growth: The Latin American Case, LATEA, January 1996.


No. 38: Effective Financing of Environmentally Sustainable Development in Latin America and the Caribbean, LATEN, January 1996.

No. 39a: Argentina: Mutual Fund Regulation, LATAD, October 1996.


No. 39c: Brazil: Securities Portfolio & Investment Fund Regulation, LATAD, October 1996.

No. 39d: Chile: La Regulación de los Fondos Mutuos, Fondos de Inversión, y Fondos de Inversión Extrajera, LATAD, October 1996.

No. 39e: Chile: Los Fondos Mutuos, LATAD, October 1996.

No. 39f: Colombia: La Regulación de los Fondos de Valores, LATAD, October 1996.

No. 39g: Mexico: Mutual Fund Regulation, LATAD, October 1996.

No. 39h: Peru: Mutual Fund Regulation, LATAD, October 1996.