Corporate Governance Reform Issues in the Brazilian Equity Markets[1]

by

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Abstract

The Brazilian equity market is characterized by relatively low liquidity, high cost of capital (low firm valuation), and limited new capital raising. Ownership concentration of corporations is high, with large wedges between control and cash flow rights, leading to large differences in pricing of non-voting and voting shares, reflecting the risks of expropriation by insiders. In recent years, much of the trading and new issuance activity has also migrated abroad. To enhance the development and the functioning of the Brazilian equity markets, beside macro-stability and lower interest rates, improvements are needed in the corporate governance framework, particularly regarding the protection of minority rights, better rules for and oversight of institutional investors, and a better trading environment, including lower taxation.

** Authors' Note: This paper was written in early 2000, based on the conditions in Brazil at that time and the paper does not purport to be current or to address the current corporate governance or equity market issues in Brazil*

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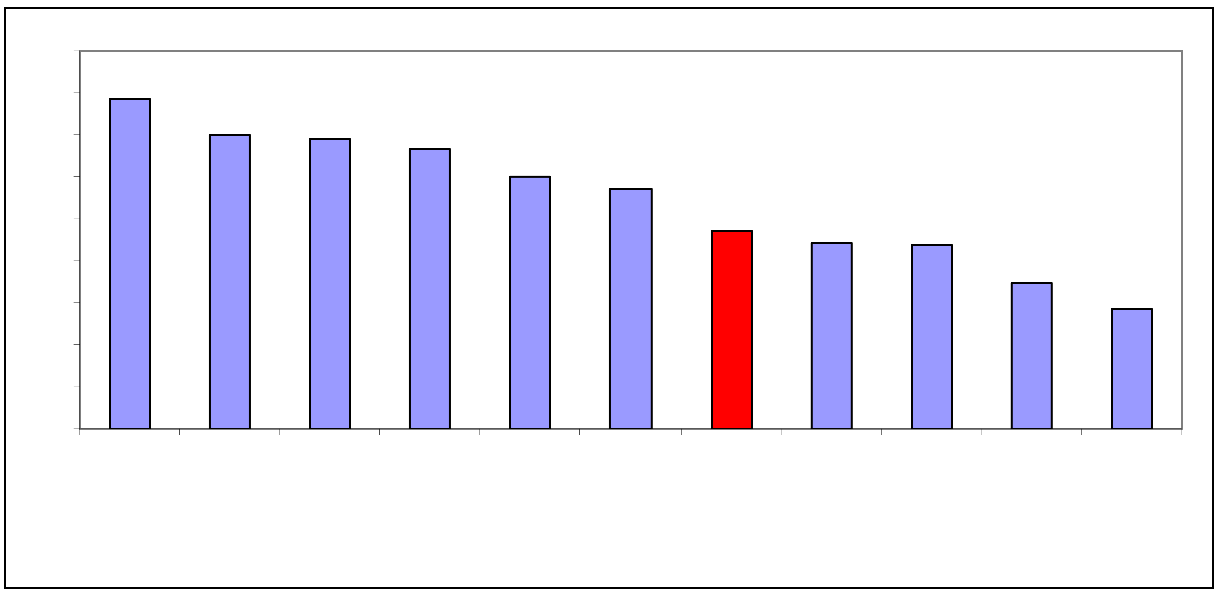
Summary

Large, but not liquid equity market. True to the size of its economy, Brazil's equity market has the largest market capitalization of the Latin American region. But the market is concentrated in a small number of large companies and the number of listed shares has been declining in recent years. Controlling shareholders maintain large stakes, liquidity is low as the "public float"—mostly of non-voting shares—is low, and volatility of stock prices has been high. Shortcomings in the legal and regulatory framework contribute importantly to the risks of investing and the high costs of capital and low valuation. Price-earning ratios in Brazil have historically been below those of developed markets and many emerging markets (Figure 1). Risks to investors are exacerbated by the dominance of majority-controlled corporations and the large wedge between the interests of controlling and outside shareholders. These deficiencies put Brazil at a competitive disadvantage in attracting capital, from domestic and foreign sources, as confirmed by rankings of international institutional investors on the quality of the corporate governance framework in Brazil. An improved framework for corporate governance is key to ensuring an active capital markets and efficient allocation of resources. Without such reforms, Brazil may risk a less favorable perspective by international investors and domestic funds becoming captive resources.

Figure 1. Price /Earning ratio, end 1999



Source: Emerging Markets Database (EMDB).

Going forward, the Brazilian equity market is at a crossroad. It is unclear whether sufficiently vibrant domestic equity markets that allocate capital efficiently will develop in Brazil. Macro-stability, declining real interest rates, increased demand of the corporate sector, and a larger supply of domestic savings under institutional management in Brazil are positive factors. But, to assure that the increased savings are allocated efficiently, improvements in equity markets' laws and infrastructure and better governance of institutional investors are necessary. Without these changes, a captive market with poor resource allocation may result. And, as the de-listing of firms (due to going private or foreign take-overs) and the migration of trading and raising capital offshore continues, new issuance may continue to be minimal and liquidity may dry up further. Corporations interested in improving their corporate governance to lower their costs of capital—and signaling their intention to do so to external financial markets—will not wait for improvements in domestic markets, but rather list and raise funds offshore. Globalization and developments in information technology and the greater use of the internet—which opens new opportunities for investors to invest abroad at relatively low costs—further raise the risks of a declining importance of local capital markets.

Brazil would have much to gain from a well-developed equity market. Equity markets raise financing for investment and provide diverse financing opportunities for larger firms. They can improve the corporate governance of firms and enhance the allocation of resources. They matter for the growth of new firms as they offer financing for new, innovative firms and exit vehicles for venture capitalists financing middle-market and new-economy firms. Across countries, more developed and more active capital markets are associated with higher rates of economic growth.[2] And well-balanced financial systems with financial intermediation by both banks and capital markets can also absorb shocks better.

Equity markets are part of a country's overall financial system. Across countries, it is the overall development of the financial sector that matters most for growth and financial sector development, rather than the exact balance between banks and capital (equity) markets.[3] While important for new firms, equity markets appear most useful in improving the allocation of resources, rather than necessarily in providing large amounts of new financing for existing firms. Furthermore, equity markets are "high cost" markets: they need a very good, enforced legal framework; high-quality information; well-governed institutional investors; sufficient size; supporting public and private sector institutions; etc. Making equity market development an independent goal can therefore misguide attention.

Developing Brazil's equity markets requires much the same preconditions as developing Brazil's overall financial sector. Much of the infrastructure needed to develop a financial system is common to banks and equity markets: sustained overall macro-stability, reduced interest rates and attractive returns for various classes of assets, improved legal foundations, and the enforcement thereof, and lower taxation of financial intermediation. The development of the Brazilian equity markets specifically will depend on enhancing minority rights protection, improving the corporate governance of institutional investors in Brazil, lowering the transaction tax, and improving the structure and enforcement of regulation and supervision.

1. Macro stability and lower real interest rates are necessary to make investment in equities (and corporate bonds) more attractive. To date, rates of return on equity have been often less than those on government bonds and bank deposits, less risky financial instruments. The large supply of government bonds has crowded out the demand for equity investments among domestic institutional and other investors. While the prospects of continued macro stability and fiscal deficit reduction have increased lately, it will continue to require attention.

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[2] See Levine, 1997 for a survey as well as Rajan and Zingales, 1998, and Levine and Zervos (1998).
[3] Levine (2000), Demirguc-Kunt & Maksimovic (2000) and Beck and Levine (2000).

2. *Strengthen corporate governance***.** Brazilian companies have been slow to adopt best corporate governance practices, such as independent directors and board committees. In a recent survey, more than 60 percent of respondent companies professed ignorance of the Code of Best Practices issued by the Brazilian Institute of Corporate Governance. The prevalence of non-voting shares in Brazil discourages good corporate governance practices and outsiders have little tools to discipline insiders. Company management of many corporations are not focussed on maximizing shareholder value, deterring outside investors and raising the cost of outside equity. The initial public offering market has been stagnant and the number of listings has declined as companies have been "taken private" through buyouts by controlling shareholders, often in a manner unfavorable to minority shareholders.

Stronger protection of minority investor rights, including rules for treatment of outside shareholders in M&As, and improved enforcement is needed. Across countries, firms' valuation are lower with weaker shareholder protection, with values in Brazil estimated to be some 20 percent or more lower compared to countries with best practice property rights. And, controlling for liquidity in shares, voting premiums in Brazil are high, with an estimate premium of about 23 percentage points. While normally voting premiums reflect the value of control arising from better corporate management, in Brazil today they reflect the value to insiders of expropriating resources from minority shareholders, made possible by weak property rights and poor enforcement thereof. In some transactions, values offered to minority shareholders have been only one-seventh of those paid by controlling shareholders. If Brazil had good investor protection, it is estimated that the voting premium in Brazil would be 11 percentage points lower. And, with a better quality of takeover laws, voting premiums would be another 9 percentage points lower. Correspondingly, firm valuation would be higher, the cost of capital for firms lower and new issuance more attractive to investors, both domestic and foreign, with corresponding gains as less profitable investment opportunities would be bypassed.[4]

Brazil is in the process of undertaking many enhancements to its corporate governance framework. The specific elements of the legal and regulatory regime for protection of shareholders rights which need to be most urgently improved through changes in the corporate and securities laws and securities markets' regulations are: permanent moratorium on issuance on non-voting common shares; equal treatment of minority shareholders in changes of control; mandatory fiscal councils; greater representation of non-voting shareholders on corporate boards and fiscal councils; and improved disclosure of board practices and audit reports. Stronger creditor rights will need to complement these changes to enhance the role of banks in the monitoring and disciplining of corporations.

3. *Governance of pension funds and other institutional investors.* Relative to the size of the local capital markets, mutual funds and pension funds in Brazil have substantial investible resources. Institutional funds are also expected to grow substantially in the future, with some estimates predicting a more than doubling of total pension funds in the next five years (see further World Bank, 1999). While most of these funds are currently allocated to government

[4] These changes would not necessarily lead to more trading domestically, as the global trend is toward concentration of trading in a few markets. Other countries have tried to improve regulations, lower costs, and facilitate public offerings, among other things, without much success in enhancing the liquidity of their domestic markets.

bonds, as macro stability is taking hold and real interest rates decline, some of these resources will be invested in the corporate bond and equity markets. To avoid resource misallocation, corruption and fraud, a high premium needs to be placed on ensuring that the pension and mutual fund industries are properly governed and regulated, and do not become a captive source of funds for insiders. Moreover, pension funds, especially some public employer sponsored funds, could play a more active role in the corporate governance of corporations. Pension funds will, however, only exercise a proper role in the governance of corporations in which they have substantial ownership if they themselves are properly managed and have adequate incentives to maximize risk adjusted returns on their assets. Asset allocation regulations can not substitute for these basic requirements. While Brazil has adopted laws and regulations to ensure better governance and regulation of the pension and mutual fund industry over the last few years, there is still significant room for improvement.

Key reform areas include: further strengthening of professional management; enforcing recently introduced asset valuation (mark-to-market) rules; requiring annual independent audits of pension funds; and moving to a truly "prudent person" investment regime as the governance of pension funds is improved (which in turn requires, among others, reviewing the legal liability of directors and imposing fiduciary duties on directors, and liberalizing the investment regime of funds, including regarding foreign investments). As mutual funds have become important players in Brazil's capital markets, and taking into account the limited supervisory capacity, mutual funds should be required to be organized as companies with independent boards of directors elected by investors that will be responsible for monitoring asset managers. As companies, funds would be subject to normal auditing and accounting requirements, have annual shareholders' meetings, and directors would have legal duties and liabilities.

4. Lower financial transaction taxation and enhance the structure and enforcement of supervision. Financial transactions in Brazil are currently subject to a turnover tax of 0.38 percentage points, which will be lowered in the next few years. In contrast, most capital markets today do not have turnover taxes. This high taxation has lowered liquidity of the local markets and has encouraged trading to move offshore. Evidence from other countries suggests that the sensitivity of liquidity to taxes can be quite high. Transaction costs in Brazil, about 1.6 percentage points, while average for emerging markets, are high compared to many developed countries. The high taxes and trading costs have led to the migration of much trading abroad, especially to the US which has much overlap in trading time. While this has meant a lower cost of capital for some firms, it has meant reduced domestic liquidity. Lowering over time the transaction tax and making the trading systems and brokerage markets more competitive would help boost liquidity of the domestic market.

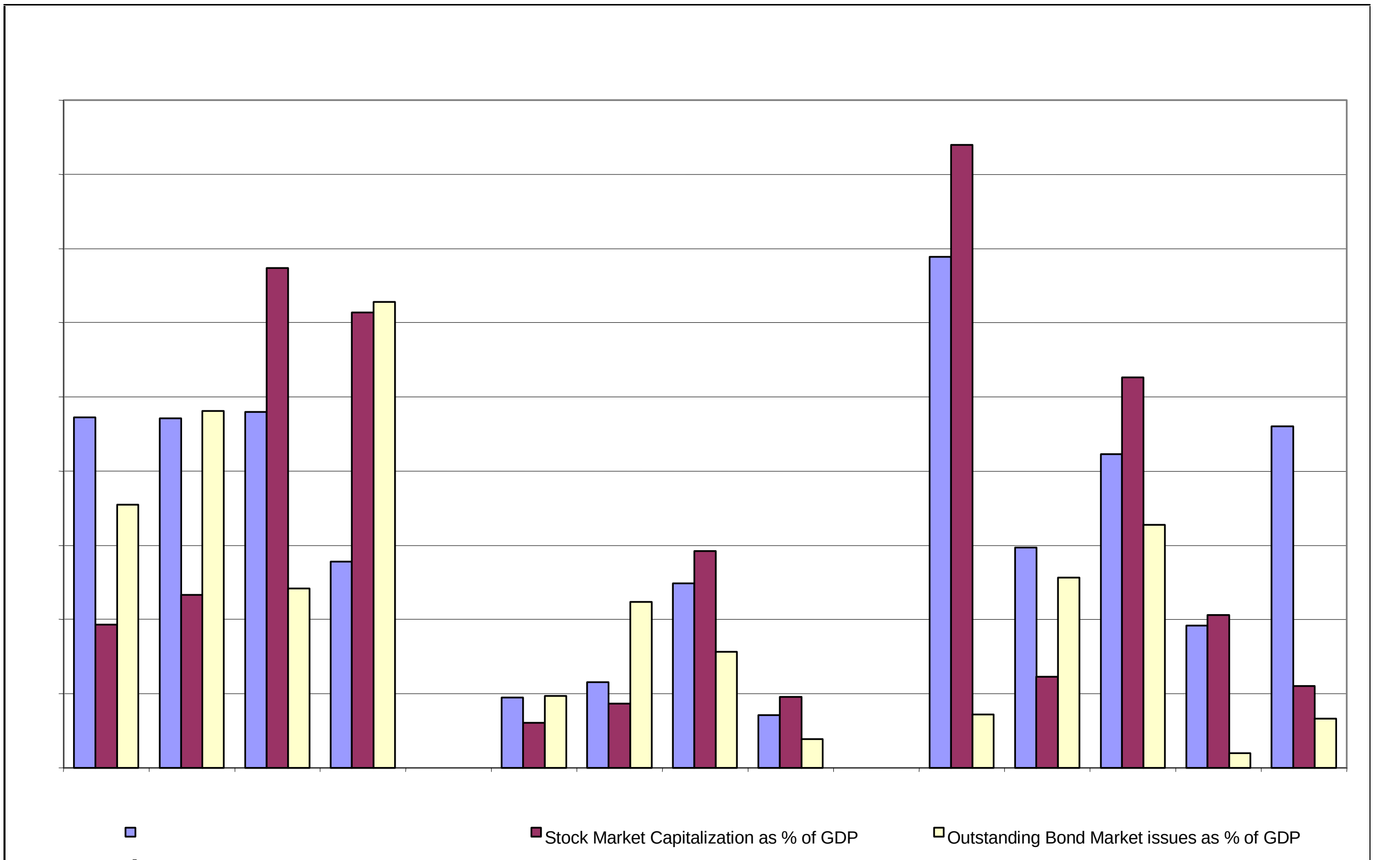
Reforming the regulation and supervision of capital markets will be necessary, requiring, among others, sufficient and secure (autonomous) budgets for an improved, restructured CVM and other regulators. Regulators also need enhanced independence, including fixed terms for chairpersons and board members. In addition, continued training and professionalization, and enhanced transparency in regulation and supervision will be key. And, although likely limited in the short-run, there is need for a greater, more effective role of a limited number of self-regulatory agencies in assuring market integrity and professional conduct.

Further studies and other reforms. The reforms outlined above are essential, but only first steps towards enhancing the functioning of capital markets in Brazil. Further steps are needed in enhancing the role of self-regulatory agencies (including the stock exchange BOVESPA) through law or regulation; more wide-spread adoption (through regulations) of best practice codes in underwriting, mutual fund operations, trading and corporate governance of financial intermediaries; a greater role of not only regulators but also other parties in publicizing wrong-doings; and enhancing trading systems. Important ancillary, supporting functions, such as accounting, credit information agencies, and others, need to be enhanced as well. Exact detailed reform measures and their sequencing will require further study.

I. Financial Markets in Brazil: Background

The Brazilian financial markets. Compared to other countries, and with the exception of the government bond market, which is relatively large, Brazilian financial markets are relatively underdeveloped (Figure 2). This underdevelopment applies to private bond markets, stock markets and banks. The low private sector intermediation reflects years of unstable macro-developments and a weak legal infrastructure in Brazil.[5]

Figure 2. Structure of Financial Systems (end-1998)



Source: Beck, Demirguc-Kunt, Levine, 1999.

Financial intermediation to the private sector in Brazil is dominated by bank-intermediated funds and private capital markets are only about half the size of all (bank) intermediated funds. In 1998, of the financing going to the private sector, bank credit was 41 percent of GDP, private bonds 13.5 percent and stock market capitalization 20.7 percent (Table 1). Of the traded fixed-income securities, government bonds dominate, 40 percent of GDP, which are most often held by banks, in part to fulfill high reserve requirements. These ratios have remained relatively stable over the last four years, different from many other countries where corporations have increasingly switched to capital market financing.

Table 1. Assets by Type

[5] See Beck, 2000. Many of the issues facing Brazil also prevail in other Latin America and emerging markets, See, for example, World Bank 2000 for the case of Mexico.

(percent of GDP)

	1995	*1996*	*1997*	*1998*	*1999*
Public bond market capitalization	17.54	23.98	28.71	40.09	30.56
Private bond market capitalization	12.21	10.2	10.02	13.48	7.07
Stock market capitalization	20.92	27.97	31.86	20.74	29.17
Banking systems assets	46.69	47.67	48.9	58.41	55.08
Banking system domestic credit	37.51	39.75	42.29	41.11	43.28

Source: Central Bank of Brazil.

Rates of return. Macro-instability, large fiscal deficits and volatile exchange rate movements have meant that over the last two decades equity claims on Brazilian companies have not offered very attractive rates of return to investors compared to returns available on government bonds, bank deposits and foreign assets, even abstracting from risks. The annual all-in, real rates of return on equities over the last five years has been a 7.65 percent, compared to more than 20 percent on government bonds and around 12 percent on bank deposits (see Table 2). Returns have thus mostly favored government bonds in the capital markets and otherwise directed funds to bank deposits. Dividend yields have been very low, and capital gains have been very volatile. More generally, the large supply of government bonds has crowded out equity investments. On the basis of recent trends in achieving macro stability, one may expect that going forward equity investment will become more attractive asset classes.

Table 2. Returns, Turnover, and Concentration

	1995	*1996*	*1997*	*1998*	*1999*	*Average*
Rates of return, percent per annum, adjusted for inflation (CPI)						
Bank deposits (%)	-13.76	10.69	17.42	24.80	21.16	12.06
Equity market (BOVESPA, %)	-74.47	27.96	27.24	-37.08	156.47	7.65
Stock market						
Value Traded / market capitalization (%)	50.66	49.97	76.83	87.51	39.08	60.81
Share of top 15 corporations in total market capitalization (%)	63.45	60.58	62.98	63.28	67.51	63.56

Source: CVM, BCN, and EMDB.

Stock Market Activity. While large, the Brazilian equity market is not very active and overall turnover was only about 40 percent in 1999, low compared to most markets and falling over the last three years (see Table 2). Turnover is concentrated, with the largest 15 firms representing 68 percent of turnover in 1999. (In the past, trading has been even more concentrated; in 1996, trading in Telebras alone represented 65 percent of all trading volume.) A significant part of the trading, often of the stock which used to be more actively traded locally, has migrated abroad over the last decade: one of eight Brazilian companies and practically all the major companies of the BOVESPA index have an ADR in New York. ADR-trading in New York today exceeds that on the BOVESPA, suggesting that the ADR-listings have resulted in lower trading volumes on the BOVESPA. And the total value of shares held through ADRs outside Brazil was some US$27.58 billion at end-1999, about 12 percent of the overall Brazilian stock market capitalization. The market is also concentrated in a small number of companies—

the top 15 firms account for more than 60 percent of capitalization, and a declining number of listed shares. Controlling shareholders maintain large, non-traded stakes, and the "public float" is a small fraction of market capitalization, and mostly in non-voting shares.

Investors. Pension funds and mutual funds are the most important institutional investors in Brazil, amounting at end-1998 to 13.5 and 10.3 percent of GDP respectively.[6] These investors are expected to grow substantially in the future, with some estimates predicting a more than doubling of total pension funds in the next 10 years (Source: ABRAPP, Association of Brazilian Pension Funds). Banks have been important investors in government bonds, in part due to high reserve requirements and reluctance to lend to the private sector. Foreign investors have been important in the equity markets, but much less so in the bond markets as regulations have limited investments in the past.[7] The percentage of BOVESPA's market capitalization represented by foreign investors is 23 percent, down from a high of 32 percent in 1997 (these numbers exclude the share of stocks held by foreigners through ADRs and GDRs). Even more than domestic investment, foreign investment is concentrated in a limited number of stocks. And, even when excluding trading offshore through Brazilian ADRs, foreign portfolio investment in BOVESPA represents a high share of the real public float and trading volume, also as domestic institutional investors so far have mostly invested in government bonds. The development bank BNDES has been an important, although declining supplier of both debt and equity financing; the private equity part of BNDES, BNDESPAR, for example, accounted for about 8 percent of overall market capitalization at end-1998.

Firm financing patterns during the late 1990s. Reflecting the low level of financial intermediation, and not atypical of other Latin American countries, firms in Brazil have relied mainly on internal financing for investment. Table 3 provides the financing pattern of Brazilian publicly listed firms for the 1994-1998 period (the figures are on flow basis and provide the share of financing for new investments). The share of external financing has been small over this period, and is much below those recorded in the early 1990s.[8] To the extent external financing is used, it has mostly come from banks, and only to some extent from capital markets. Importantly, the share of external financing has actually declined over the period, from 32.2 percent in 1999 to 27.7 percent in 1998. The 1998 crisis induced a sharp rise in trade financing as firms saw their access to domestic and international financial markets sharply curtailed and had to resort to other sources of financing. In general, external financing has largely been going to the largest firms over the years 1994-98, with close to 70 percent of total financing going to the 20 percent of largest firms (Figure 3).

Table 3. Firm Financing Patterns, 1994-1998

(Publicly-listed firms, sorted by size)

[6] To avoid double counting and provide a figure that accurately reflects the supply of funds by investors, assets under management by mutual funds is cited net of pension funds assets invested in mutual funds. At the end of 1998, closed and open ended pension funds had invested 30.9 percent of their assets in mutual funds raising the actual assets under management of mutual funds to 15.6 percent of GDP.

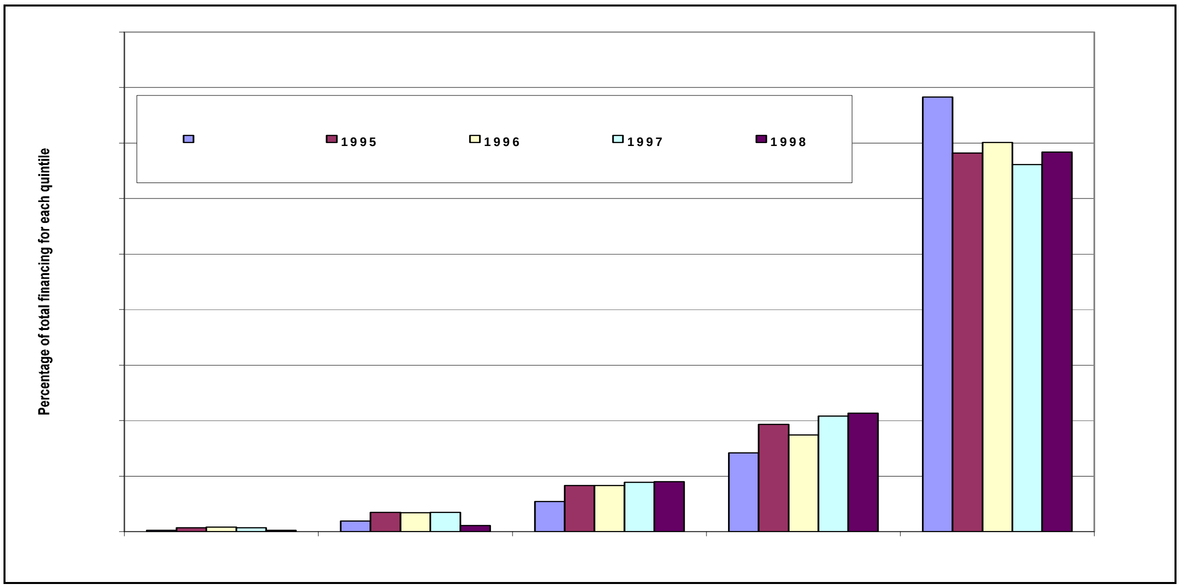
[7] As part of a broader initiative of gradual liberalization of the Brazilian capital account, the National Monetary Council set a time-table, starting as of March 31, 2000, for the elimination of many of the regulatory restrictions for portfolio investments of non-residents.

[8] For an analysis of financing patterns in the early to mid 1990s, see Zonenschain, undated.

	1994	*1995*	*1996*	*1997*	*1998*
Internal financing	67.8%	69.1%	69.1%	70.6%	72.3%
Banks	18.4%	17.7%	20.8%	10.8%	13.5%
Capital markets	8.4%	15.2%	12.3%	15.0%	3.7%
Trade Financing	5.4%	-2.0%	-2.2%	3.7%	10.6%
Total External Financing	32.2%	30.9%	30.9%	29.4%	27.7%

Source: Worldscope database for 156 to 170 non-financial, publicly listed corporations. Flow data.

Figure 3. Concentration of external financing among firms
(Percentage of total external financing for size quintiles of firms)



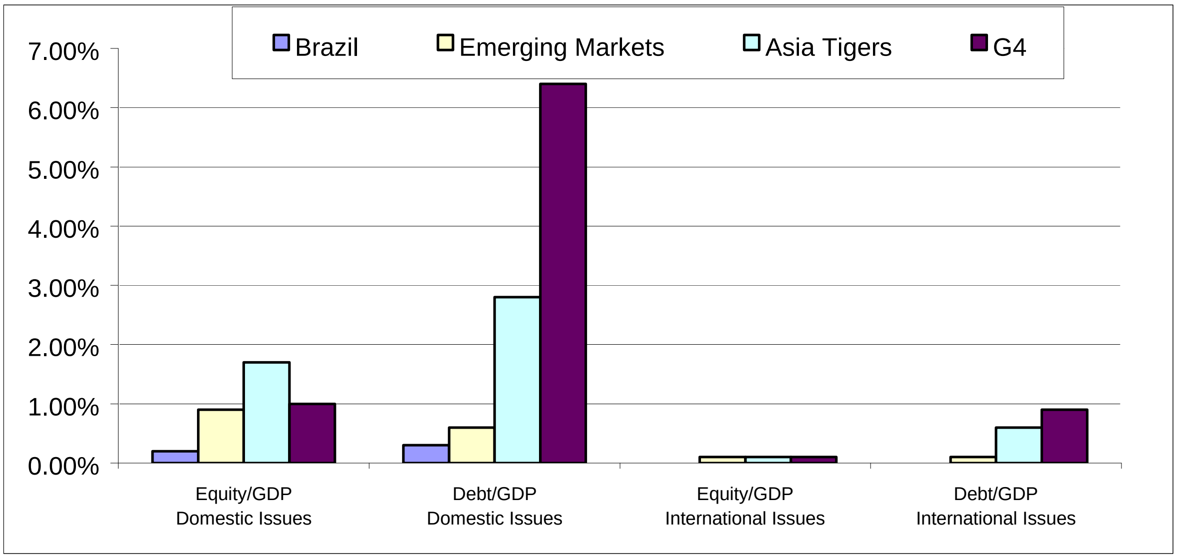
Source: 156 to 170 public-listed firms; based on Worldscope data, sorted by firm size in five quintiles.

Few new public issues. Apart from the more recent wave of ADR-related issues, there have been few new equity issues in Brazil: comparing equity issuance as a share of GDP over the 1980-1995 period, Brazil was in the bottom quartile of 36 countries (Figure 4). In the years 1994-95, Brazil had the lowest ratio of new issues to GDP (0.5 percent) and to domestic investment (2.5 percent) of 11 developed countries and emerging markets.[9] While there was much new issuance in the earlier part of the 1990s, most of this was related to ADR programs and raising of new equity offshore. Much of this new issuance was also related to floatations of stakes in state-owned corporations and financial institutions: only 37 percent of all new issuance over the 1992-96 period was related to market issues of non-financial corporations. Also, new bond financing by the private sector has been relatively spare, with Brazil also in the bottom half of the 36 countries. The poor macro-economic environment in Brazil over the past decades with high real interest rates can explain some of this, and, going forward, this can be expected to improve. Much of the lack of new issuance, however, appears attributable to the weak minority

[9] Source: Banco Icatu, "The Brazilian Stock Markets", 1997.

shareholder rights and creditor protection in Brazil.[10] The lack of new issuance not only puts limits on the growth of the equity markets, but also limits the scope for venture capital.[11]

Figure 4. New Issuance, 1980-1995
(As a percent of GDP)



Source: Aylward and Glen, 1999. Data on international issues for Brazil over this period are not depicted.

Ownership structures. The direct ownership structure in Brazil suggests much ownership by non-financial corporations (53% of voting rights and 35% of cash-flow rights), but in reality, as many non-financial firms are mere intermediate owners, more than half of all firms (51%) in Brazil are controlled by individuals (Table 4). Foreigners are the next most important ultimate owners (14.7% of voting rights), followed by domestic financial institutions (banks, pension funds, and insurance companies).

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[10] Domowitz, Glen and Madhavan, 2000b note that the differences in the degree of IPOs across countries is a function of, among others, the strength of the rights of creditor and equity holders in the respective country.
[11] Jeng and Wells 1998, for example, show that across 15 countries venture capital investments are strongly driven by IPOs (for late stage funds) and private pension fund levels.

Table 4. Direct and ultimate ownership and voting vs. cash flow rights

(By category of investors)

	Direct ownership		*Ultimate ownership*	
Category	*Voting rights*	*Cash-flow rights*	*Voting rights*	*Cash-flow rights*
Individuals	15%	11%	51%	31%
Non-state-owned non-financial companies	53%	35%	0	0
Foreigners	8%	8.1%	14.7%	13.1%
Banks and insurance companies	3.8%	2.8%	4.6%	3.2%
Pension funds	3.1%	2.5%	4.2%	3%
Others[12]	2.74%	2.10%	4.59%	2.67%
Total Non-widely held	**85.5%**	**61.7%**	**79.2%**	**53.8%**
Widely-held	**14.5%**	**38.3%**	**20.8%**	**46.2%**

Notes: The data refer to 225 non-state-owned Brazilian companies, are year-end 1996 and were collected from the CVM. The data include all shareholders with more than 5 percent of the voting capital of a company.
Source: Leal and Valadares, 2000.

Firms also have highly concentrated ownership: the largest shareholders of 225 non-government controlled, publicly listed corporations have on average 48 percent of equity capital.[13] This ownership concentration is aided by the fact that Brazilian corporations are characterized by a large use of non-voting shares (non-voting shares on non-financial companies can be up to 2/3 of total shares).[14] Voting rights are also concentrated: 62 percent of companies have a single holder who directly or indirectly owns a majority of the voting shares. Of the remaining companies, the largest direct or indirect shareholder controls on average 34 percent of the voting shares.

This ownership and control concentration has in part arisen from past incentives to list, which brought firms to the stock market which in the absence of such incentives would probably have remained privately-held by a few individuals. Specifically, government policies beginning in the 1970s forced pension funds and other institutional investors to invest in stocks. The so-called "Fundo 157" tax incentive further encouraged investments in equities, providing Brazilian companies with a ready market for whatever types of shares they cared to issue. But today, the poor protection of minority shareholders in Brazil creates a high value of control, leading to unbalanced ownership structures. Accounting for indirect ownership, realized to some extent by pyramiding structures,[15] in firms with majority owner control, the owner puts in little of its own

[12] Others include government, employees, foundations, Investment Funds, the *Câmara de Liquidaçòes e Custódia* (Chamber of Clearing and Custody), and Cultural Societies, among others.
[13] Of all corporations, the largest, three and five shareholders controlled on average 68 percent and 73 percent of voting shares respectively. Figures on the composition of equity of Brazilian companies in this section come from Leal and Valadares, 2000. See also Tagore Villarim de Siqueira, undated.
[14] Only 11 percent of companies have not issued non-voting shares, 27 percent of corporations have reached the two-thirds limit on issuance of non-voting shares, and 46 percent of equity is on average non-voting. For the larger and more established companies, the percentage of non-voting shares is typically even higher.
[15] In contrast with many other countries, the use of pyramidal holding company structures to control companies with a lower investment in total capital does not appear to be very common in Brazil. Rather, it seems often to be a mechanism for assuring concerted action by a coalition of ultimately controlling shareholders, usually a family. But, most of these other countries do not have non-voting shares to the same degree as Brazil.

capital: on average he/she needs only 37 percent of the company's capital to control the company.[16]

Brazil can therefore be characterized as a Continental European type of ownership and control pattern, rather than the US model of widely held corporations. The Brazilian ownership pattern is similar to many emerging markets, where families, financial/industrial groups or small numbers of shareholders acting in concert usually exercise control.[17] But, of the major markets in Latin America, ownership of voting shares is most concentrated in Brazil and Mexico (in the latter an average of 65.6 percent are in the hands of controllers and 43.8 percent of major listed companies had more than 70 percent in the hands of controllers).[18] The biggest contrast in the region is with Chile, where holding of pension funds other institutional investors and ADR programs sometimes amount to a majority of the outstanding shares, although not for the largest corporations and conglomerates.[19] (Non-voting shares are not present in Chile.)

While today government incentives to list no longer exist, past policies continue to affect the equity market and its development. Insider owners have been reluctant to increase minority rights protection, as they would loose the value of control. As non-voting shares are more available and typically more liquid than voting shares, institutional investors have largely invested in non-voting shares. The advantages of increased liquidity have made these investors less interested in improving corporate governance as a means to enhancing rates of return. And, due to legal requirements on minimum dividends (non-voting shares have to have dividend payments 10% higher than voting shares), the rates of return on voting and non-voting shares have not differed as much, although differences in relative valuation are high.

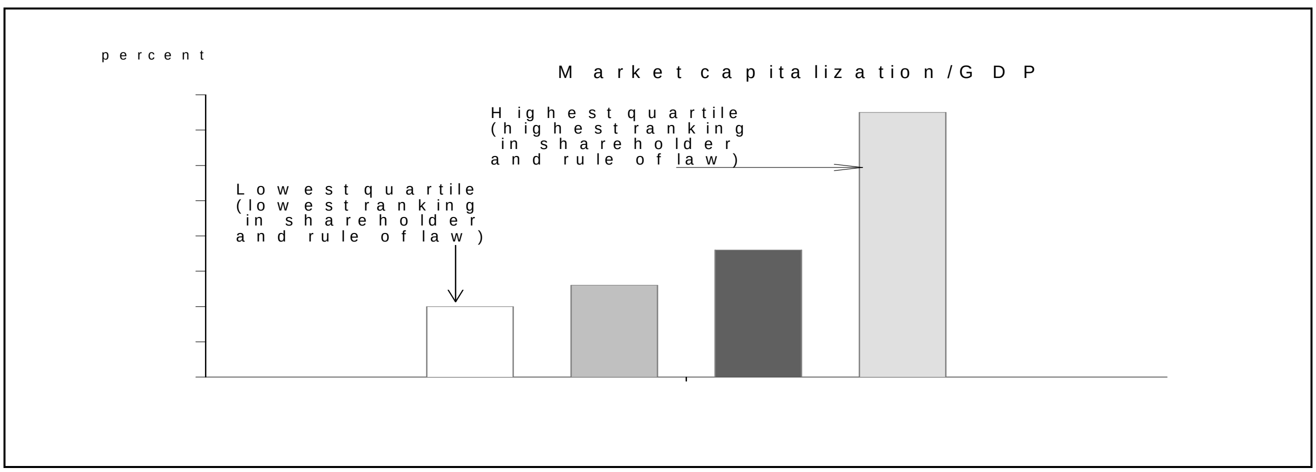
[16] Controlling shareholders almost always have more than the bare minimum of voting shares they need for control (17 percent) and are often important investors in non-voting shares as well. The average majority shareholder holds 74 percent of the voting and 53 percent of total equity, but if one examines ultimate beneficial ownership (i.e., looking through holding company structures) the figures come down to 55 percent and 37 percent.
[17] La Porta et al., 1999b.
[18] Castañeda Ramos, and Claessens, et. al,, 2000a.
[19] Leforte and Walker, 2000.

II. Corporate Governance Framework

Corporate governance in emerging markets concerns minority rights protection. Corporate governance can be defined in many ways. Most often it refers to the structure, rules and institutions that determine the extent to which managers act in the best interest of shareholders. But in many countries, as in Brazil, ownership is very concentrated and owners can monitor managers' actions quite well.[20] Furthermore, the separation of management from ownership control is not the norm, rather management and ownership control frequently coincide even in the largest publicly traded corporations, especially in emerging markets. In East Asia, for example, management of two-third of firms is family-related to the controlling owner.[21] Essentially, management is the controller's alter ego in most corporations in emerging markets.

The main principal-agent problem in many countries is therefore not conflicts of interest between owners and managers, but rather conflicts between majority and minority shareholders, with associated risk of expropriation. The strength of minority rights and their enforcement is an essential part of limiting the scope for expropriation. Across countries, capital markets development is a declining function of the degree of shareholder protection (Figure 5). And across firms. Equity market values are higher when shareholder protection is stronger.[22] Correspondingly, the cost of capital for firms is higher in weak corporate governance settings, which has social costs as profitable investment opportunities are bypassed.

Figure 5. Capital market development and quality of shareholder protection



Source: La Porta et al., 1997.
Notes: Quartiles of 40 countries ranked by shareholder protection and rule of law.

The formal, written corporate governance framework in Brazil is average for the region. Compared to major Latin American markets, and using the methodology developed by La Porta et al. 1997, Brazil scores about average on most measures of the written legal framework

[20] La Porta et al., 1999b.
[21] Claessens et al., 2000a.
[22] La Porta et al. 1999a.

shareholder rights (Table 5). Brazil generally scores better than Mexico, but worse than Chile and is about on a par with Argentina. Provisions for trading of securities after the record date of a shareholders' meeting, the percentage of shares needed to call a meeting, and formal rights against controlling shareholders and directors are above average for the region, although well below most OECD countries.

Table 5. Shareholders' Rights and Corporate Governance Practices

	One Share/ One Vote	*Shares Not Blocked Before Mtg*	*Cumulative Voting/ Prop. Representation*	*Shares To Call ESM*	*Preemptive Rights*	*Oppressed Minority Remedy*	*Share-holders Rights [a]*	*Mandatory Tender Offer in Change of Control*	*Independent Directors*	*Committee Practices*
Chile	Yes	Yes	Yes	0.10	Yes	Yes	5	Under Consideration	Pension Funds appoint Directors	Audit Committee Requirement Under Consideration
Argentina	No	No	Yes	0.05	Yes	Yes	4	No	No	27% of Boards have standing committees
Brazil	Yes [b]	Yes	No	0.05	No	Yes	3	Repealed in 1997 [c]	No	17.6% of Boards have standing committees
Mexico	No	No	No	0.33	Yes	No	1	No	No	Recommended in Code

Source: La Porta et al., in The World Bank, "Beyond the Washington Consensus: Institutions Matter," 1998, updated with World Bank/IFC Corporate Governance Assessments for Chile, Brazil and Mexico; and Spencer Stuart Business Indexes: Brazil, 1999 and Argentina, 1998.
a. La Porta et al. 1997 index is the sum of five 0-1 indicators: the country allows shareholders to mail their proxy vote; shareholders are not required to deposit their shares prior to the General Shareholders' Meeting; cumulative voting is allowed; an oppressed minorities mechanism is in place; the minimum percentage of share capital that entitles a shareholder to call an Extraordinary Shareholders' Meeting (ESM) is less than or equal to 10%.
b. Only among ON shares. PN shares can have limited voting rights.
c. Only for ordinary shares.

However, Brazil scores poorly with respect to proportional representation of shareholders on boards, anti-dilution and, importantly, the principle of one-share one-vote.[23]

[23] It is important not to confuse Brazilian non-voting PN shares with the kinds of preferred shares issued and traded in Europe and North America. These latter are in effect mezzanine securities with legal and economic characteristics somewhere between those generally associated with debt and equity. Their terms generally provide for fixed or minimum (and usually cumulative) dividends. The holders of such shares acquire the right to vote at shareholders meetings only if fixed or minimum dividends are not paid for some set period. Accordingly, unless they are combined with an option to convert to common shares, the market characteristics of preferred shares

The divergence from the principle of one share/one vote is especially important as on average 46 percent of shares, and a much larger portion of public float and almost the entire trading volume of the BOVESPA, are non-voting. As a result, Brazil is an extreme case in the region and elsewhere in terms of the divergence between control and cash flow rights. (Mexico is the only other major market in the region with a variety of non-voting and limited voting shares. This is largely as a legacy of 1980s-era foreign investment rules in Mexico that restricted the percentage of voting shares that could be held by foreigners.)

And enforcement has been weak. Whatever the quality of laws may be, enforcement of rights is essential. Across countries, for example, the mere existence of insider-trading laws does not make a difference in firms' costs of capital. Insider-trading laws that are enforced, however, reduce the cost of equity by about 5 percentage points per year.[24] Again, Brazil does not score high in enforcement. Judicial enforcement, largely in the hands of often ill-prepared state court judges, remains weak and CVM has lacked the capacity to aggressively investigate cases and act on violations. From the date of act to final CVM ruling, for example, rulings completed over the period 1996-99 took on average more than five years, with a period of initial investigation alone of more than two years. And, after the CVM ruling another two year passed in the appeal process with the CRSFN, making for a total of more than seven years. And, as CVM limits its market surveillance almost exclusively to off-site monitoring, with on-site inspections only on specific demand, detection of violations by CVM is very sporadic.

Foreign investors share this perception. Investors have become increasingly concerned with corporate governance issues in Latin America. McKinsey, in cooperation with the World Bank, surveyed in mid-1999 institutional investors to establish their concerns on the issue of corporate governance, and priorities for reform. Respondents to the survey represented 90 institutional investors with global assets holdings of US$1.65 trillion. Of these, 31 percent were Latin American institutions, with the balance between European and U.S. investors. Approximately 70 percent of respondents either were, or had been, invested in Latin America.

Over 80 percent of respondents stated that, relative to financial considerations, they viewed corporate governance issues as important in their investment decisions. When asked to rank which issues in corporate governance were of most concern in Latin America, a majority cited shareholder rights as the first priority, followed by disclosure, and lastly, the boards of directors. Notably, views regarding the ranking of priorities differed between foreign investors, where 71 percent considered shareholder rights as the priority, whereas just 33 percent of local investors considered this the first concern. On disclosure and boards of directors, local investors were most concerned (56 percent and 42 percent) whereas for foreign investors, the two issues lagged shareholder rights considerably (48 percent and 12 percent respectively). The survey also asked investors whether they would be willing to pay more for companies with international standards of corporate governance. For Brazil, 89 percent of respondents stated that they would pay an average premium of 22.9 percent. This was higher than the premium cited for Chile, Mexico or Argentina, suggesting that the corporate governance environment may be viewed as

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generally resemble those of debt instruments. In contrast, the vast bulk of Brazilian PN shares (which may under current law account for up to two thirds of total capital of non-financial, non-foreign controlled public companies) provide for no fixed or minimum return (other than 110 percent of whatever dividend is paid to ON shares).

[24] Bhattacharya and Daouk, 2000.

weaker in Brazil. These survey results thus suggest that the gains from improved corporate governance are considerable at the individual firm level in terms of lower cost of capital.

Leading to weak corporate governance practices. The impact of weak minority rights is reflected in actual board practices where minority shareholders have very little representation and transparency is lacking. Truly independent directors are uncommon in Brazil and standing committees are rare. (Indeed, investment and finance committees are still more common than audit committees: note that the so called fiscal board in Brazil is not an audit board only). As indicated in Table 6, outside directors are less common in Brazil than in Argentina (44 percent vs. 63 percent), and to what extent Brazilian outside directors are truly independent is not known (only 21 percent of Argentine directors are truly independent, the US figure is 79 percent). Only 17.6 percent of Brazil boards have committees for special issues, compared with a still very low 27 percent in Argentina and 100 percent in the U.S. Best practice, as reflected in the code issued by the Brazilian Institute of Corporate Governance, recommends that each Board have an audit committee and that the company's independent auditors report to the committee or (in its absence) to the Board as a whole. However, in 37.5 percent of companies surveyed, the auditors report to the CFO only; and in another 33.7 percent the auditors report to the CEO only. Only in 21.2 percent of companies do outside auditors report to the Board or an audit committee.[25]

Table 6. Board Composition and Practices

	CEO is Chairman	*Average No. of Directors*	*Independent Directors Normally/Truly Independent*	*Representation by Minority Shareholders*	*Presence of Board Committees*	*Average No. of Annual Meetings*	*Presence of Foreign Directors*
Argentina	N/A	8.6	63%/21%	N/A	27%	16	17%
Brazil	29.70%	6.8	44% /N/A	20%	17.6%	8.8	32%
USA		13	79%	100%	100%	7	47%

Source: Spencer Stuart Board Indexes: Argentina 1998; Brazil, 1999; USA, 1999.

Poor creditor rights aggravate the impact of weak minority rights. In some respects, Brazil's bankruptcy code is better than others in the region: there is no legal stay of foreclosure by secured creditors upon a debtor's reorganization filing; and unsecured creditors can oppose an abusive reorganization filing by a debtor. But these advantages exist only on paper and many shortcomings exist: debtor-friendly reorganization (concordata) procedures (debtor in possession); tax and labor claims which have liquidation priority over even secured claims; poor predictability of outcomes because of broad discretion of trial courts; often vague and almost always time-consuming procedural requirements; absence of a workable trustee in bankruptcy system; unfair treatment of foreign-currency denominated debts; etc. Procedural practicalities, over-burdened and usually poorly prepared state courts, lack of clear rules with respect to valuation and solvency, and multiple levels of appeals, add to the weaknesses.

[25] Figures in this section come from Spencer Stuart Board Indexes: Argentina, 1998; and Brazil, 1999. Note that the survey on the Brazil Board Index was characterized by a relatively poor response rate, so figures may not be fully indicative.

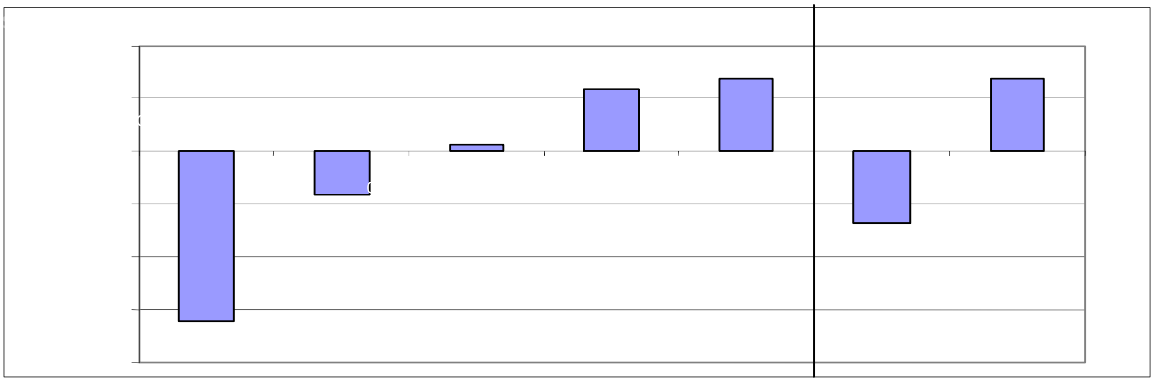
These weaknesses have a large effect on financial intermediation in Brazil, especially the availability for finance for small and medium enterprises, and growth.[26] They also affect the corporate governance of firms. Creditors are not able to perform a serious role in monitoring and disciplining corporations: they end up extending loans at high spreads with, in spite of formal convenants, little formal assurance on being able to recover loans, leading to poor due diligence and monitoring.

Weak minority and creditor rights induce expropriation. The weak rules and limited enforcement of minority and creditor rights interact with ownership structures to create an overall loss of firm value and higher cost of capital. Corporate governance problems are particularly severe when ownership structures are very concentrated and when there are large deviations between cash flow rights and voting rights as those create large incentives to disrespect minority rights and expropriate value.[27] Forms of expropriation include low dividends, the channeling of funds to (private) companies, excessive diversification, higher management compensation, etc. The anticipation of expropriation is reflected in the lower valuation of minority shares; to attract investors, firms end up paying high costs of capital, as the risks of expropriation are high. This in turn leads to high voting premium, lower valuations, higher cost of capital, less new equity issuance and worse allocation of resources. All these effects are present in Brazil, as in many other emerging markets, with differences in firm valuations (between firms with the most and no divergence of cash flow rights and control right) of 20 percentage points or more (Figure 6).

[26] See Beck, 2000.

[27] Using data of firms in 13 countries, Nenova 1999 finds that the premium for voting rights largely reflects private benefits, rather than control premium, which in turn depend on the country's minority shareholder rights. Claessens et al., 2000b find that deviations between voting rights and cash flow rights explain value discounts in nine East Asian corporations. Procianoy and Snider, 1994, find that firms' dividend policy in Brazil depends on ownership structures, with firms with one controlling owner paying lower dividends, even after changes in taxation in 1990 meant that dividend income was not taxed, while capital gains were subject to a flat tax.

Figure 6. Firm value and the divergence between cash flow and control rights
(Sample of 2,000 East Asian corporations)

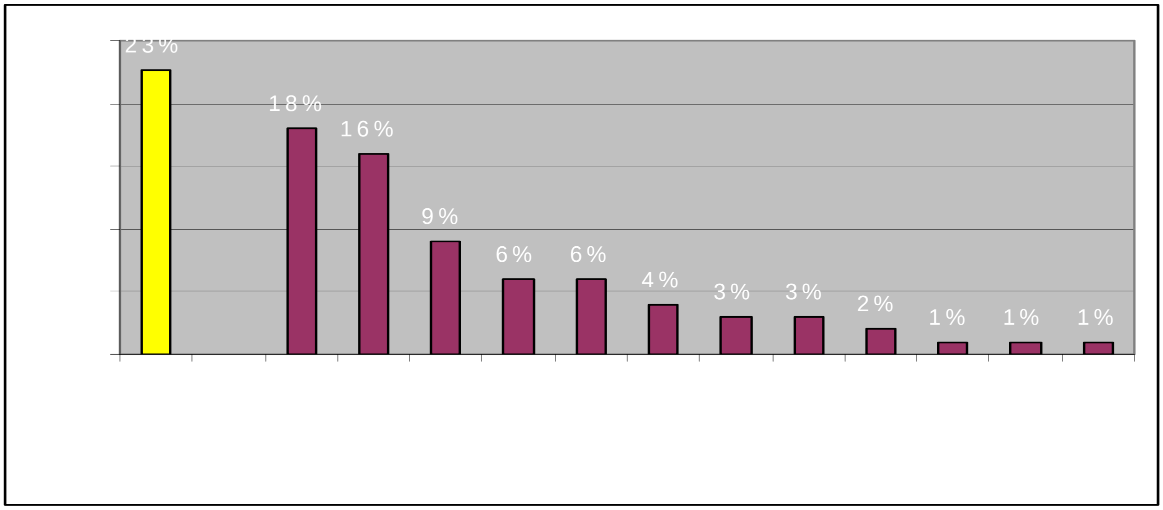


Source: Claessens et al. 2000a.
Note: the chart depicts the (standardized) value of firms in relation to the ratio between cash flow rights (C) and voting rights (V). When there is no divergence, C=V, firm values are the highest; when divergence is the largest, C/V<0.25, firm values are the lowest.

The average voting premium in Brazil (correcting for the effects of differences in liquidity, firm dividend policies and preferences of shares) is 23 percentage points, the highest among 13 countries (Figure 7).[28] Higher voting premiums in Brazil are associated with more concentrated ownership structures. Voting premiums thus do not reflect the normal control premium arising from improved management of the corporation, but rather the value insiders obtain from diverting resources made possible by a weak corporate governance framework. Taking into account size, dividend, liquidity and other differences, voting premiums across firms in 13 countries decrease in the strength of the corporate governance framework (Nenova, 2000). Compared to these other countries, the weak quality of investor protection in Brazil explains 54 percent of its high voting premium, and the quality of takeover laws explains the remaining 46 percent of the premium.[29] Put differently, the average premium for voting shares in Brazil would decrease by 10.67 percentage points if the quality of investor protection went from actual to the highest possible level. Similarly, if the quality of takeover laws went to the highest possible value, the average voting premium would decrease by 9.26 percentage points. On the whole, firm values in Brazil are likely at least some 20-percentage points lower than in other countries on account of the weak property rights.[30] Or, put differently, the cost of capital in Brazil has been at least 5 percentage points higher on account of the weak property rights.[31]

[28] The voting premium (the ratio of prices of voting share relative to the price non-voting shares minus one) typically displays a U-shaped behavior with respect to ownership concentration. With relatively dispersed ownership, there can exist a market for control, which gives rise to a voting premium for block ownership. With very high ownership concentration and in weak corporate governance settings, there is a large private benefit from control, leading to high voting premiums as well which reflects the value insiders gain from the private benefits when having control over firm resources. At intermediate level of ownership concentration, voting premiums are generally the lowest as there is neither a market for control nor large private benefits.
[29] These are effects keeping all other values constant. See further Annex 1.
[30] LLSV 1999a find that the difference between strong and weak corporate governance countries in the market to book value of equity is about 20 percent.
[31] This calculation uses a real discount rate (rate of return) in Brazil for equity of 25 percent.

Figure 7. Voting premiums for 13 countries



Source: Nenova, 2000.

High cost of capital in Brazil reflects a high voting premium and low firm valuation. These effects are also observed across Brazilian firms.[32] Firms with individual (family) ownership have the highest voting premium, followed by widely-held, state-owned, and foreign-held companies. In general, voting premiums in Brazil follows a U-shaped pattern with ownership concentration. This suggests that the voting premium of family-controlled firms reflects the possibility of expropriating resources from ordinary shareholders, while for the widely-held firms it reflects that a normal market for corporate control allows the intrinsic value of control to be incorporated in firm market valuation. Correspondingly, firm values are the lowest for majority, closely-held (Tobin's Q, market to book value of assets of 1.00), and the highest for majority foreign-owned corporations (Tobin's Q of 1.40).[33] Firms that are held indirectly and for which private benefits from control are the most, are also lower valued, consistent with the potential of minority shareholder expropriation.[34]

Other evidence of the importance of the corporate governance framework comes from the change in the protection of minority rights in May 1997 which revoked the rules for tender offers to allow for easier privatization of state-owned enterprises to consortiums of domestic investors. This resulted in significant value losses: at announcement, the valuation of those firms with ownership structures, which were possible candidates for take-overs, dropped. The voting premium also fell, by about 27 percentage points (correcting for other factors), as the loss in value was more important for the ordinary, voting shares than for non-voting shares, since the pre-1997 tender offer requirement applied only for the benefit of voting shares.[35]

[32] Nenova, 1999 and Siato, 2000. See also Villarim de Siqueira (undated) who finds that for 278 Brazilian corporations ownership concentration has a negative impact on financial performance over the period 1994-96.
[33] State-owned enterprises are valued even lower, a Tobin's Q of only 0.96.
[34] See further also Leal, Da Silva and Valadares, 2000.
[35] See further Siato, 2000.

And leading to perverse effects on liquidity and new issuance. The current mix of voting and non-voting shares is also affecting capital market liquidity, although in a perverse way. Non-voting shares are most liquid on the organized exchanges. Transactions involving voting shares generally take the form of large off-exchange block trades, with low liquidity. Since, under current circumstances, the infra-marginal voting share has few advantages (there is no longer a requirement for equal treatment in changes of control), a "liquidity trap" exists with non-voting shares commanding a liquidity premium over voting shares, although their intrinsic value is less because of the risk of expropriation. This liquidity trap means that there are few market mechanisms forcing controlling shareholders to treat minority rights better and enhance firm values.

Market forces can help, but will not be enough. The evidence above shows that the current legal and regulatory framework in Brazil combined with the prevalence of non-voting shares limits the incentives for good corporate governance practice and maximization of shareholder value by managers, and impedes capital market development. The problem is largely the result of past economic distortions and some unfortunate policy decisions (e.g., the May 1997 repeal of the change of control tender offer requirement). Arguments can be made that market forces can resolve corporate governance problems: the cost of capital, for example, will reflect how well a firm treats its shareholders and creditors. To some degree, this is correct. Corporations, which need to attract external financing, will improve their internal business, provide more information to shareholders and creditors, invite outsiders on the board, etc. Some of this is taking place in Brazil, as demonstrated by firms trying to obtain funding from international markets and subjecting themselves to the more stringent corporate governance requirements abroad.[36]

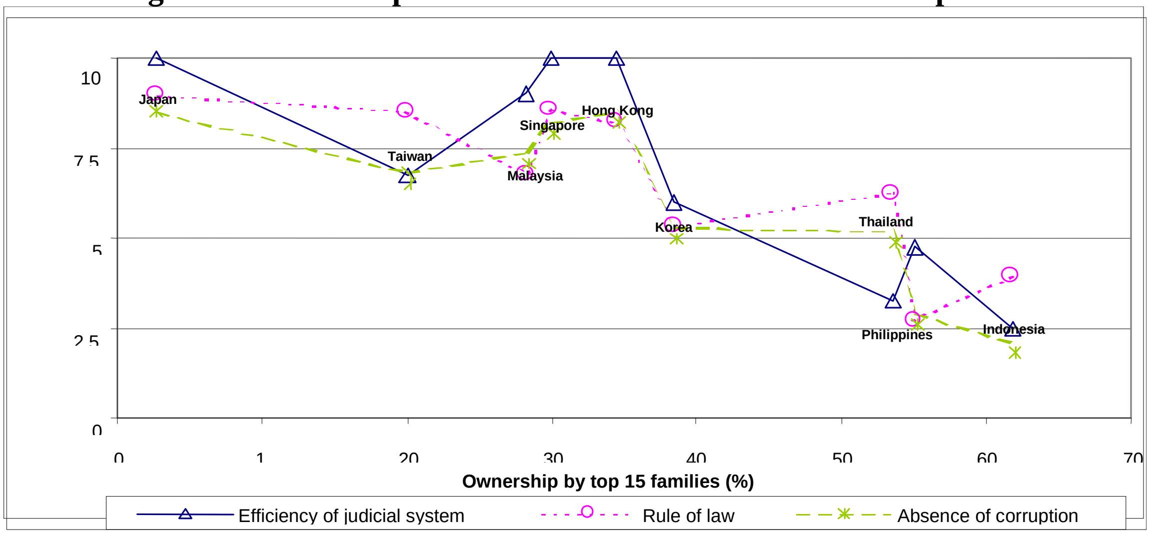
Market forces could also improve the extent to which companies issue non-voting shares. Arguably, equity securities with different voting characteristics need not retard market development, as freedom to structure contracts between investors and companies is generally a good idea. On the other hand, a proliferation of differently structured claims creates market fragmentation, reduces liquidity, impedes price discovery, and complicates enforcement. Brazil's extreme divergence from the one-share-one-vote rule is clearly damaging both market development and company performance. The perverse effects on liquidity are preventing market forces from resolving the lack of voting shares.

More generally, market forces will not suffice, in part as corporations can not bind themselves and need to rely on the enforcement of rules by outsiders. And, importantly, there are many externalities in creating a better corporate governance framework. Few investors, for example, would trust an individual corporation's governance in a country with very weak overall rules. And in many other developing countries, there have been powerful interest groups against corporate governance reforms due to the domination of insider control. Across East Asian countries, for example, concentration of ownership of the whole corporate sector among a limited number of families has had a negative association with the general framework for investors' protection and efficiency of the judicial system (Figure 8). As such, poor corporate

[36] Although not all corporations listed abroad do so, but those that do not see this reflected in lower valuation relative to comparable, international firms.

governance and bad ownership structures can be part of a vicious cycle, which needs to be broken by improved laws and more widely held ownership of the corporate sector. Again, pressures on the country as a whole from international financial markets will provide some impetus for change, but these incentives often remain limited.

Figure 8. Ownership concentration and institutional development



Source: Claessens et al. 1999.
Note: Share of majority ownership of all publicly listed corporations owned by the top 15 families in the country.

Improve creditor rights. The changes outlined above should be complemented by changes in the creditor rights to strengthen the role of creditors in promoting good corporate governance. While, as in other Latin American countries, bankruptcy reform has been on the agenda in Brazil for much of the past decade, little progress has been made. In the meantime, important reforms have been undertaken in Argentina (1995) and have been approved recently in Mexico. Brazil needs to accelerate its efforts and learn from reform efforts elsewhere, particularly Argentina. Priority reforms in Brazil include a re-ordering of claims in liquidation and introduction of a workable process for restructuring troubled, but viable companies (under trustee administration, not debtor-in-possession). Reforms also need to allow for market mechanisms for trading and consolidating claims, and procedures to accommodate repossession of collateral in secured finance. To date, possible advocates for reform—creditors (largely state-owned) and *potential* borrowers—have not proven successful. It means reform will require continued public education about the link between certainty of treatment of creditors in bankruptcy and the availability (and cost) of finance in order to reverse the general tendency in Brazil to favor debtors at all costs.

This need for reform applies equally to Brazil's laws on security interests, which are fragmented among the civil code, the commercial laws, financial sector legislation and special laws for certain kinds of instruments (e.g., mortgage securitization). Recent legal innovations, such as the use of trust-type mechanisms (alienacao fiduciaria) to increase the prospects for effective enforcement, are a (useful) stopgap measure. But Brazil still needs to move to a uniform code governing the creation, perfection and enforcement of securities' interests. Efforts in this direction are already underway in Argentina and legislation is under consideration in

Mexico. Comprehensive reform of secured transactions law needs to be accompanied by reforms to the bankruptcy law (particularly in the area of priority of claims) for it to have the desired effect.

III. Developing Better Institutional Investors

Background: Size and Role of Institutional Investors.

Overall Size. Compared with other Latin American countries, with 28.9 percent of assets to GDP, the size of institutional investors is significantly larger in Brazil than in all other Latin American countries except for Chile (Table 7).

Table 7. Assets held by Institutional Investors in Latin America
As a percentage of GDP (December 1998)

	Pension Funds	*Insurance*	*Mutual Funds*	*Total*
Argentina	3.3	1.3	2.1	6.4
Bolivia	3.9	0.5	2.8	7.2
Brazil	**10.3**	**3.01**	**15.6**	**28.9**
Chile	40.3	13.5	4.6	57.2
Colombia	2.1	1.5	0.3	4.0
El Salvador	0.4	0.8	0.0	1.3
Mexico	2.7	1.7	3.6	8.0
Peru	2.5	0.6	0.5	3.5
Uruguay	1.3	0.8	0.7	2.8
Venezuela	0.0	1.4	0.1	1.5
Average	*7.2*	*1.8*	*7.8*	*15.3*

Source: Private pension systems and policy issues: OECD, 2000

The main suppliers of funds in the Brazilian capital markets are mutual funds and pension funds. The funds of these institutional investors amounted to 80.2% and 49.6% respectively of stock market capitalization[37] and 88.0% and 54.5% respectively of market turnover in 1998. Both types of investors are expected to grow quite rapidly in the future.

Mutual Funds. The Brazilian mutual fund industry has been growing rapidly over the last few years and, with 16 percent of GDP at end 1998, is relatively well developed by emerging markets' standards (Table 8). Brazil's mutual fund industry is by far the largest in Latin America. The industry has also grown rapidly in terms of number of funds offered to investors, with in June 1999, 2,667 mutual funds operating, up from 667 at the end of 1993. Brazilian banks dominate Brazil's asset management business with Banco do Brasil, Bradesco, and Itau controlling 41.2% of all funds. In terms of investors, 40% of all funds under management in Brazil come from retail clients, 20% from closed pension funds and 30% from other clients (private banking, open pension funds, insurance companies, etc).

Table 8. Relative role of classes of investors
Relative shares

[37] Since these institutional investors currently hold largely government bonds, the fractions exceed actual stock market investments.

	1995	1996	1997	1998
Pension Funds				
% of GDP	8.5	9.1	10.1	9.7
% of savings	51.3	57.1	65.9	65.4
% of deposits	26.4	30.2	33.3	
% of market capitalization	40.7	32.5	31.8	49.6
% of turnover				
Mutual Funds				
% of GDP	10.6	15.8	15.7	15.6
% of savings	64.0	99.1	102.8	105.6
% of deposits	32.9	52.4	52.0	
% of market capitalization	50.8	56.3	49.6	80.2
% of turnover	94.6	108.9	62.3	88.0
Foreign Portfolio Investors				
% of GDP	2.6	3.5	4.0	2.2
% of savings	15.9	22.0	26.0	14.2
% of deposits	8.2	11.6	13.2	7.9
% of market capitalization	12.6	12.5	12.5	10.8
% of turnover	23.6	24.2	15.8	11.8
BNDESPAR				
% of GDP	n. a.	n. a	1.6	1.7
% of savings	n. a.	n. a	10.6	10.5
% of deposits	n. a.	n. a	5.4	5.9
% of market capitalization	n. a.	n. a	5.1	8.0
% of turnover	n. a.	n. a	6.5	8.8

Source: Banco Central do Brazil. n.a. = not available

The growth of mutual funds in recent years can partly be explained by the tax advantages they enjoy. Mutual funds are not subject to the transaction tax (CPMF) and investors only have to pay CPMF if they invest new money or liquidate their holdings. This has encouraged many pension funds to create mutual fund type vehicles to avoid the CPMF. Most mutual funds assets are allocated to fixed income: as of June 1999, 79% of all funds was allocated to so-called 60-day fixed income funds and only 9.4% to stock funds (Table 9). Yet, against the background of a stabilizing macro environment and declining interest rates, net assets invested in stock mutual funds have risen rapidly during 1999, increasing by almost one third from US$ 9.5 billion to US$12.5 billion from March 1999 to March 2000 (Source: CVM).

Table 9. Types of Mutual Funds
(share of total asset sizes, percent)

	Dec-96	Dec-97	Dec-98	June-99
Stock funds	5.0%	11.8%	9.3%	9.4%
Money market funds	22.3%	5.1%	5.5%	3.6%
Fixed income (30 day funds)	4.6%	6.9%	8.4%	7.6%
Fixed income (60 day funds)	68.1%	76.2%	76.8%	79.4%
Total	100%	100%	100%	100%

Source: Comissao de Valores Mobiliaros (CVM).

Pension Funds. Pension funds in Brazil refer to the complementary voluntary private pension schemes, also referred to as occupational pension schemes, that were put in place in

1977 and coexists with the government's pay-as-you-go system. There are three types of private systems: (1) closed pension funds; (2) open pension funds; and (3) individual retirement funds.[38]

Closed funds comprise the largest category with 297 funds and over 90 percent of total assets. Although private companies established most closed-end pension funds, the largest funds (such as Previ) are related to government entities. The largest five funds are public funds and together control almost 50 percent of all pension assets (Table 10). Public funds are operated as not-for-profit agencies, where net income is directed to the affiliates. To date, these funds are mainly funded defined benefits schemes, although many private employers are now encouraging beneficiaries to switch to defined contribution schemes, with associated transfer of funds. These funds are supervised by SPC (Secretaria de Previdência Complementar).

Open funds are open to any worker and are set up as for-profit or not-for profit agencies. Over the last twelve months, these funds have experienced the largest growth, doubling in number to 80. These funds are supervised by SUSEP (Superintendencia de Seguros Privados).

Individual retirement funds were created at the beginning of 1998 and consist of ten-year minimum investment funds for workers who do not have access to closed funds (self-employed, etc). At the end of ten years, workers may withdraw the funds or obtain a retirement plan. These funds are supervised by SPC.

[38] See Report No. 19641-BR, Brazil: Critical Issues in Social Security, *The World Bank 1999.*

Table 10. Top closed end pension funds ranked by net assets
(May 1999)

Fund	*Company*	*Ownership*	*Assets (in millions of US $)*	*% of total pension fund assets*	*Participants Number*	*% of total participants*
Previ	Banco do Brasil	Public	14,489	26.4	72,486	4.4
Funcef	CEF-Caixa Economica Federal	Public	3,299	5.9	54,822	3.3
Sistel	Telebras	Public	3,244	5.8	58,776	3.6
Petros	Petrobras	Public	2,805	5.0	42,044	2.5
Centrus	Banco Central do Brazil	Public	2,130	4.4	26,142	1.6
Cesp	CPFL, Eletropaulo		1,965	3.7	25,923	1.6

Source: ABRAPP.

Asset Allocations. Closed pension funds, the most important segment of the Brazilian pension funds, invested the bulk of their funds in fixed income securities (40.5% at end 1999) and stocks (25.9%), Figures 9a and 9b. Since 1993, equity investments by Brazilian pension funds have ranged between 30% and 40% (Table 11). Brazilian pension funds can legally be the majority shareholder of a company. A large percentage of the equity investments in pension funds are in companies in which pension fund managers are members of the Board of Directors. In addition to equity holdings, pension funds invest 8.5% in real estate assets, with closed pension funds being important investors in hotels and shopping centers. Lending to sponsoring companies also continues to be high.

Table 11. Closed-end Pension Funds' Asset Allocation
in percent of total assets

Asset class	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Fixed Income Securities	30.8	30.6	36.1	66.9	44.5	41.6
Shares	34.8	39.1	29.5	33.5	39.2	29.4
Real estate	16	14.4	14.9	12.9	10.4	10.7
Lending to participants	4.2	6.5	7.7	7.3	6.4	6.3
Lending to sponsor	7.8	7.8	9.4	6.9	7.4	8.4
Other	6.4	2.6	2.5	2.4	2.2	2.6
Total	100	100	100	100	100	100

Notes: Shares include equity investment in sponsoring company.
Source: *Secretaria de Previdência Complementar*, ABRAPP.

Figure 9a: Company-Sponsored Closed Pension Funds: Total Assets (R$ billion)

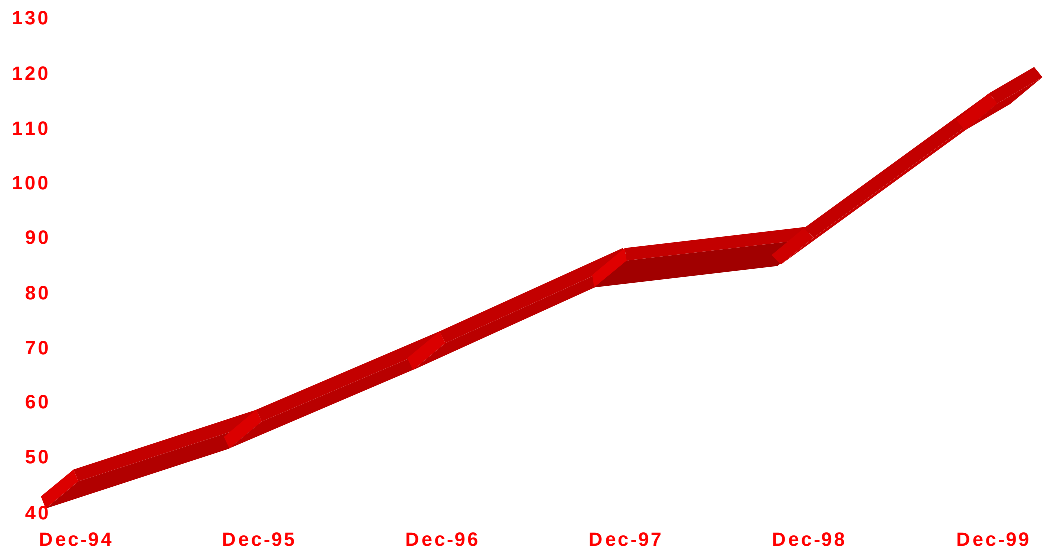
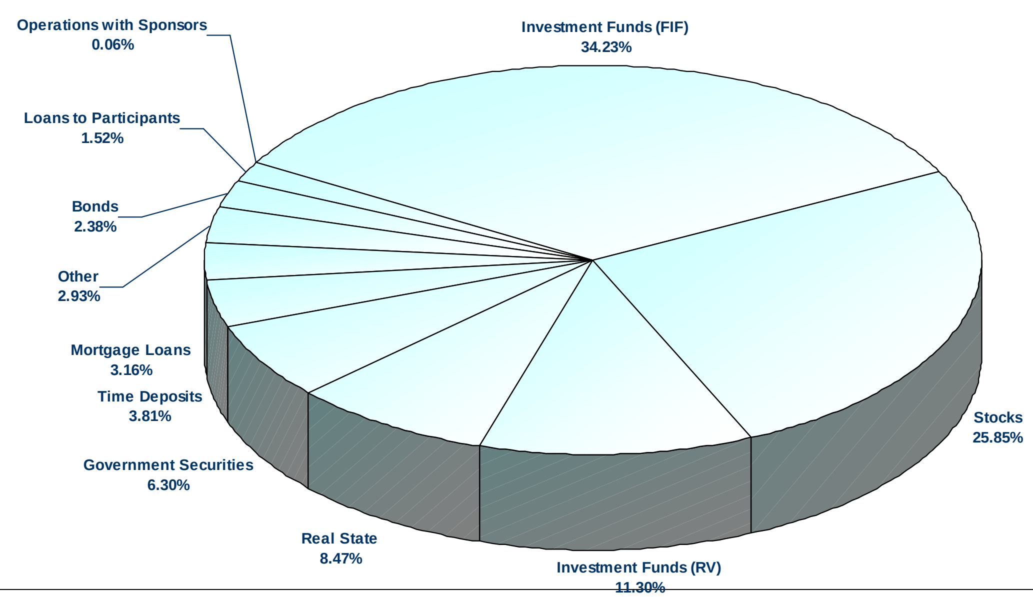


Figure 9b: Portfolio Allocation
Share of Total



Source: Banco Central do Brasil, Focus, July 4, 2000.

Insurance companies. In 1998, insurance company assets accounted for less than 5% of GDP. Brazil's insurance premiums represent only 2.1% of GDP, about one-half of Chile's and Malaysia's but higher than those of Mexico and Peru and similar to Argentina and Thailand.[39] Three lines of insurance (auto, health, and life) account for almost two-thirds of all activity in the sector. Bradesco and Sul-American Aetna, a traditional insurance company, dominate the Brazilian insurance market and together account for 34% of premiums. Insurance companies are supervised by SUSEP.

Foreign Investors. Foreign portfolio investor participation increased steadily through 1990s reaching a high of 34.6 percent of BOVESPA market capitalization in January 1998. Foreign portfolio investment has been carried out under various mechanisms, mostly dating back to 1987 when the markets were first opened to foreigners. The main mechanisms were so called Annexes targeted at different types of investors, which imposed specific portfolio restrictions and often offered favorable tax treatment. The government then sought to regulate the flow of foreign portfolio investment by varying the level of the tax on exchange transaction. As investment rules and regulations were perceived to be excessively restrictive and bureaucratic, effective March 31, 2000, the government lifted many portfolio investment restrictions, with foreigners now being treated similar to resident investors.

BNDES/BNDESPAR. BNDESPAR is the equity investment and investment banking arm of publicly owned BNDES. It was set up in 1982 to pursue the following objectives: (i) to support investment in the economy; (ii) to stimulate restructuring; (iii) to stimulate the development of new financial products; and (iv) support the privatization process of state-owned companies. At end-1998, BNDESPAR investments accounted for only 8% of overall market capitalization, but with its investment banking activities it is an important player on the issuance side.

Rules and regulations under which investors operate

Relative to the size of the Brazilian capital markets, pension funds and mutual funds have substantial investible resources, that are also expected to grow rapidly in the coming years. According to a recent estimate (ABRAPP, 1999), pension fund assets are projected to double over the next five years. To ensure efficient resource allocation and well functioning capital markets, these investors need to be properly regulated and governed and have the correct incentives to play a disciplining role in the governance of non-financial corporations.

Pension funds. The purpose of pension fund regulation is prudential and includes all regulations that aim to ensure the financial soundness of the pension funds. The most significant regulations are: (i) minimum capital; (ii) asset segregation; (iii) safe custody of assets; (iv) professional asset management; (v) asset valuation and auditing of financial statements; (vi) disclosure requirements and governance structure of funds; and (vi) asset diversification.

The Brazilian system for pension funds is largely in line with international standards in the first three aspects. Closed funds must be set up as foundations and be legally separate from sponsoring employers. Improvements in fund governance may nevertheless be required to

[39] Swiss Reinsurance Company Economic Research and Consulting.

ensure that the prescribed legal segregation is effective in practice, an important issue since the current fragmented supervisory structure may result in insufficient oversight. Without strong oversight it is not easy to ascertain that pension fund assets are effectively segregated in practice, even when held by a legally separate foundation. The law also provides for the use of independent custodian institutions. The existence of large automated clearing centers for three major types of securities (government bonds, corporate bonds, and corporate equities) makes the offer of custodian services easier and economical. In practice, however, both the regulation and supervision of custodian arrangements need to be strengthened in order to minimize the risk of fraud and misappropriation of funds.

The main weaknesses in the Brazilian regulatory system arise in five aspects: professional asset management, asset valuation, asset diversification, disclosure and governance structures. And, as different pension funds fall under separate regulators, there are areas of inconsistencies in regulation and supervision and possible gaps.

Professional asset management. As pension funds have large amounts of investible resources, their proper management is important to avoid resource misallocation, corruption and fraud. For a long-time, assets, especially in the case of public pension funds, were not professionally managed as the implicit government guarantee for the plan's beneficiaries raised moral hazard issues. Recent privatization of large public companies and improvements in regulations, such as separation of pension fund assets from company assets (especially for public funds), curtailing of direct investments in and loans to sponsor companies, have highlighted the importance of proper professional management of pension fund assets.

Pension funds have recently been authorized to hire external asset managers and a large number of funds are now outsourcing management. Currently, about half of all closed funds have external management, and another quarter has mixed management. External management is mainly concentrated in private company funds and much less in public funds (Table 12). Public funds are often much larger than private funds and may thus have a more optimal scale to manage assets in-house. However, international experience has shown that external managers provide effective and objective benchmarks for in-house managers and contribute to upgrading skills and technology. Therefore, large public pension funds would stand to gain by increasing the amount of assets managed by external managers. Furthermore, a number of funds only recently started to implement asset liability frameworks and other tools that are common for the proper management of pension funds. Despite considerable progress, ensuring that the existence of adequate professional skills is given consideration during the licensing process of asset managers could further professionalize asset management.

Table 12. Asset Management of ten largest public and private closed pension funds

Public	*Management*	*Private*	*Management*
Previ/BB	Internal	Sistel	Internal
Funcef	Internal	Valia	Internal
Fundação Cesp	Internal	Aerus	Internal
Petros	Internal	Itaubanco	External
Centrus/BC	Internal	Telos	Internal
Forluz	Internal	IBM	External
Real Grandeza	Internal	Femco	Mixed
Fapes	Internal	Usiminas	Mixed
GEAP	Internal	CCF	External
Prevhab	Internal	PSS/Philips	Mixed

Source: Secretaria de Previdência Complementar.

Valuation of assets and auditing of financial statements. Recently instituted valuation standards that require funds to mark their assets to market and undergo regular audits by independent auditors to certify the funds' financial statements have corrected a major weakness of the regulatory framework for pension fund. Valuation rules play a very important part in ensuring that the financial standing of a pension fund is properly reflected in its financial statements and allow judgements to be made on whether pension fund assets are adequately and efficiently diversified. Failure to use proper valuation rules could result in the creation of hidden reserves or hidden losses, either, of which would have undesirable implications. Moreover, lack of marking assets to market on a frequent (daily) basis may adversely affect market liquidity, as it induces buy and hold investment strategies. Accurate and timely information on pension fund assets are important monitoring and governance tools for the board of directors of the funds and the supervisory authority. Many of the recently adopted regulations go a long way towards this international best practice, but strict enforcement of these rules will be necessary. To that effect, appropriate tools and processes for the monitoring of these requirements will need to be developed by the supervisors. And, in line with international best practice, financial statements of the funds should be certified every twelve months by an independent outside auditor.

Asset allocation restrictions. The investment regime put in place in Brazil in 1994 has been similar to that in other Latin American countries with private pension systems and more restrictive than regimes in OECD countries that mostly apply the "prudent man rule" (Table 13).

Table 13. Pension Fund Asset Limits

(In percent)

	Govt. Securities	*Equity*	*Corporate bonds*	*Bank securities*	*Real Estate*	*Private Equity*	*Foreign assets*	*Prudent person rule*
Argentina (Mandatory system)	65	35	40	28	Included in private equity	10	10 foreign equity: 7%	Yes, single issue/r, minimum risk rating limits
Brazil (end-1998 rules)	**100**	**50**	**80**	**Included in equity or bonds**	**20 + 10 in real estate funds**	**5**	**10**	**Yes, single issue/r, minimum risk rating limits**
Chile (Mandatory system)	50	37	45	50	10	5	12 foreign equity 6%	Yes, single issue/r, minimum risk rating limits
Colombia (Mandatory system)	50	30	20	50	n.a.	n.a.	0	Yes, single issue/r, minimum risk rating limits
Mexico (Mandatory system)	No limit	0	35	10	n.a.	n.a.	0	Yes, single issue/r, minimum risk rating limits
Poland (Mandatory system)	No limit	40%	n.a.	20%	n.a.	n.a.	5%	n.a.
Switzerland (Occupational)	No limit	30%	No limit	No limit	55%	n.a.	30% maximum 25% max in foreign equity 55 max in foreign property	n.a.
Netherlands (Occupational)	No limit	No limit	No limit	No limit	No limit	No limit	No limit	Prudential norms
UK (Occupational)	No limit	No limit	No limit	No limit	No limit	No limit	No limit	Prudential norms
US (Occupational)	No limit	No limit	No limit	No limit	No limit	No limit	No limit	Prudential norms
France (occupational)	Minimum 50% in EU public bonds (for ARCCO and AGIRC assets); Maximum 15% in Treasury deposits	-	-	-	Maximum 40%	-	-	Prudential norms
Germany (occupational)	No limits	Maximum 30% in EU equities	No limits	Maximum 25% in EU property	No limits	No limits	Maximum 20% foreign assets, 6% non-EU equities, 6% non-EU bonds	n.a.
Portugal (occupational)	Minimum 30%	-	-	Maximum 50%	-	-	-	n.a.

Shares include equity investment in sponsoring company. n. a.= not avaliable
Source: Pension fund regulators, OECD (1998,1999), Blommenstein (1998), Srinivas et. al. (1999).

In Brazil, pension funds' ceilings on investment in equities and fixed income instruments were until recently 50% and 100%, respectively (Table 14). Funds could invest up to 10% of the portfolio in foreign securities (via foreign mutual funds), and there are no additional restrictions on investment via domestic mutual funds. Pension funds may not invest more than 10% of their portfolio in the equity of a given company or, in general, in the securities of any single issuer. They may also not hold more than 25% of a company's equity. Yet, while these are the highest equity ceilings on stocks of all Latin American countries,[40] it is important to note that all other Latin American countries in Table 13 impose restrictions only on their mandatory public

[40] After Brazil, the highest ceiling on stocks is in Chile (37%). All Latin American countries restrict investment in mutual funds. In Argentina the limit is 15%, in Chile and Colombia 5%, and in Peru 10%.

schemes while Brazil is imposing them on occupational schemes. Given that Brazil has relatively more developed capital markets than many other Latin American countries, international best practice in regulation of occupational schemes suggests, once directors' legal duties and liabilities can be adequately enforced, adopting a truly "prudent person" investment regulation regime. In the interim, given the long-time nature of their liabilities, the 50 percent ceiling on equity investment in pension fund assets should be increased, including allowing pension funds to invest more abroad. Furthermore, a requirement that appropriate valuation mechanisms—using international best practice—should be adopted to ensure that illiquid assets such as real estate are valued properly.

Table 14. Closed pension fund portfolio limits, 1994-1998.

Instrument/Asset Class	*1994*	*1995*	*1996*	*1997*	*1998*
Govt. Securities	100	100	100	100	100
Other fixed income secs.	80	80	80	80	80
State and municipal debt	50	50	50	50	50
Shares, plc's	50	50	50	50	50
Real estate	20	20	20	19(2)	20
Real estate funds	0	0	10	10	10
Venture capital funds	0	0	5	5	5
Lending to participants	17	17	10	10	10
Lending to sponsor	30	30	10	10	10
Foreign securities (1)	10	10	10	10	10
Hedging instruments	3	3	5	5	5

Source: Secretaria de Previdência Complementar.
(1) Investment only permitted via mutual funds.
(2) Ceiling programmed to increase to 18% in 1999, 17% in 2000, 16% in 2001, and 15% in 2002.

In April 2000, the government issued regulations amending closed pension funds' portfolio limits by imposing specific allocation limits within asset classes, thus essentially prescribing asset allocation not only across but also within asset classes (Table 15). While these restrictions aim to ensure proper management of pension funds' assets and reduce funds' overall riskiness, they have several important drawbacks. First, they limit managers' ability to choose a risk profile for the fund that is in line with its asset liability structure. Second, through prescribing relatively narrow asset choices, these regulations can create demand for specific types of instruments, instead of letting market participants determine supply and demand of capital markets instruments. As such, these regulations can impact overall capital market development. Third, the regulations can give a false sense of prudence. To enforce these rules good information systems, proper accounting and auditing rules, and a strong regulatory capacity needs to be in place. Lacking these requirements, the rules may achieve little in practice if managers do not face the right incentives. Given these drawbacks, allocation regulations can be more than a poor substitute for the 'prudent person investment regulation regime.' [41]

[41] Until this change, the regulatory framework of pension fund investments in Brazil had a specific weakness that funds could lend to the sponsoring company and affiliates, while this is prohibited in the rest of Latin America pension and in most OECD countries (the only exceptions are Germany (10% maximum), France (33% maximum) and Japan (no limit, but minimum of 50% in bonds)). Self-investment exposes the beneficiaries to default risk of the sponsor. And, perhaps more importantly, self-investment deprives the fund of the benefits of arms-length pricing and exposes it to the risk of self dealing.

Table 15: Asset Portfolio Allocation Ceilings in Brazil as of April 30. 2001

Investment Segment/Portfolio	Ceiling
Fixed Income Investment	**100%**
Low Risk Instrument	**100%**
Medium/High Risk Instrument	**20%**
Fixed Income Derivatives	**5%**
Equity Investment	**60%**
Stock Market Index	**60%**
Blue Chips (High Liquidity)	**60%**
Arbitrage with Derivatives	**10%**
Secondary Stocks (Average Liquidity)	**20%**
Class C Stocks (Low Liquidity)	**2%**
Stock Issues	**2%**
Stock Certificates (BDR Levels II and III)	**10%**
Real State Investment	**16% in 2001 progressively declining to 10% in 2007**
Development	
Income	
Real State Investment Funds	
Other	
Special Segment	**10%**
Infrastructure Projects	
Stocks and Debentures of Corporates under Restructuring Process	
Emerging Companies Investment Funds	
Other Bonds	
Loans and Financing	**10%**
Loans to Participants	
Real State Financing	
Risk Management	**Admitted hedging operations only**
Cross-Border Investment	**Not Admitted**
Loans to Sponsors	**Not Admitted**

Source: Banco Central do Brasil Resolution n. 2720, of April 24, 2000. Other constraints apply.

Disclosure requirements of pension funds and their governance structures. Information disclosure is important for protecting worker rights in all types of pension funds. To ensure that workers are adequately informed about their current level of pension benefits, pension funds should provide their beneficiaries with information on plan rules and the accumulated pension benefits of the employees (almost similar to a prospectus) at minimum on an annual basis. In Brazil, while pension funds provide extensive data on their operations and investment to their supervisory agencies, they provide little or no information to those agencies on investment returns or administrative costs. Similarly, workers receive so far very little information about the pension plan they are affiliated with. In general, transparency and information disclosure is often well below those in OECD countries (Table 16) and could be substantially improved. At minimum, workers should receive, at least once a year, information on the pension plan they are affiliated with including information on accumulated benefits. And, investment managers of pension fund should be required to disclose information on asset allocation and return as well as administrative and other expenses in regular intervals to their board of directors and the supervisory authorities so both can adequately perform their duties.

Table 16. Disclosure and audit requirements and governance structures

	Required disclosure	*Independent audits*	*Governance structure*	*Liability of pension fund manager*
Argentina (Mandatory system)	Monthly/annual reports to contributors Weekly publication of portfolio holdings and Valuations in newspapers Daily reporting to pension fund regulator on portfolio valuation. Valuation is done at cost for "investment portfolio" – about 30% of assets and at market for all others.	Pension fund regulator can audit the valuations Annual external auditing required.	Pension fund manager and pension fund are required to be separate entities. Banks, holding companies, foreign investors, etc. are allowed to own pension fund managers subject to certain eligibility criteria. Close supervision by regulator No requirements for worker/retiree representatives to be part of governance structure. Pension funds assets are independent of pension fund managers' assets. Custody of assets only with institutions authorized by regulator.	Pension funds' return is required to be within a band (plus or minus the littlest of 30% of average or 2%) of the average industry return. If return is lower, pension fund manager compensates the contributors up to the minimum. If return is over the maximum of the band, excess is transferred to a reserve fund, from which compensation to contributors to made in case of future poor performance. If reserve fund is inadequate, fund manager is required to bring in own resources, failing which fund manager is liquidated and assets transferred to another pension fund. The government makes up the loss in the last eventuality.
Brazil (occupational)	Not required to provide information to beneficiary Provide information on operations and asset allocation to supervisory authorities.	Audit by independent auditor.	Closed funds are set up as foundations and be legally different from sponsoring companies. Assets of funds have to be housed in independent custodians.	No minimum performance requirement.
Chile (Mandatory system)	Annual reports to contributors Weekly publication of portfolio holdings and Valuations in newspapers Daily reporting to pension fund regulator on portfolio valuation. Valuation is done at market for all assets for which prices are available. Else, valuation is done by rules set by the regulator.	Pension fund regulator can audit the valuations Annual external auditing required.	Pension fund manager and pension fund are required to be separate entities. Banks and insurance companies cannot directly own pension funds, although they can do so either through their holding companies or subsidiaries. Close supervision by regulator No requirements for worker/retiree representatives to be part of governance structure. Pension funds assets are independent of pension fund managers' assets. Custody of assets only with institutions authorized by regulator.	Similar performance band as in Argentina and similar sanctions on fund manager.
Colombia (Mandatory system)	Quarterly/annual reports to contributors Weekly publication of portfolio holdings and Valuations in newspapers Daily reporting to pension fund regulator on portfolio valuation. Valuation is done at market for all assets for which prices are available. Else, valuation is done by rules set by the regulator.	Pension fund regulator can audit the valuations Annual external auditing required.	Pension fund manager and pension fund are required to be separate entities. Banks, holding companies, foreign investors, etc. are allowed to own pension fund managers subject to certain eligibility criteria. Close supervision by regulator No requirements for worker/retiree representatives to be part of governance structure. Pension funds assets are independent of pension fund managers' assets. Custody of assets only with institutions authorized by regulator.	Similar performance band as in Argentina and similar sanctions on fund manager.

Table 16. Disclosure and audit requirements and governance structures (continued)

	Required disclosure	Independent audits	Governance structure	Liability of pension fund manager
Mexico (Mandatory system)	Annual reports to contributors Weekly publication of portfolio holdings and Valuations in newspapers Daily reporting to pension fund regulator on portfolio valuation. Valuation is done at market for all assets for which prices are available. Else, valuation is done by rules set by the regulator.	Pension fund regulator can audit the valuations. Annual external auditing required. Independent "valuation" companies being established. Pension fund portfolios required being risk rated.	Pension fund manager and pension fund are required to be separate entities. Domestic banks are not allowed to directly own pension fund managers, although they can do so through their holding companies. Other investors can own pension fund managers subject to certain eligibility criteria. Close supervision by regulator No requirements for worker/retiree representatives to be part of governance structure. Pension funds assets are independent of pension fund managers' assets. Custody of assets only with institutions authorized by regulator.	No minimum performance requirements.
Switzerland (Occupational)	Annual statements to beneficiaries. Valuation at market price with some adjustments.	n. a.	n. a.	n. a.
Netherlands (Occupational)	Annual statements provided at the request of the beneficiaries. Valuation at lower of purchase or market price	n. a.	n. a.	No minimum performance requirements
UK (Occupational)	Annual report to beneficiaries covering eligibility conditions, contributions, asset allocation of fund, actuarial valuation of assets and amount invested in employer's shares or property. Valuation at market price	Yes, external audits	n. a.	No minimum performance requirements
US (Occupational)	Annual report to beneficiaries covering aspects similar to the UK. Valuation is at market price for quoted investments and at purchase price for unquoted investments.	Yes, external audits. PBGC guaranteed funds require actuarial valuations.	n. a.	No minimum performance requirements.
France (occupational)	Annual statements available to members on request.	n. a.	n. a.	n. a.
Germany (occupational)	No information provided, since information considered "unnecessary". The pension benefit guarantee corporation – Pensionskassen, insures all assets. Beneficiaries provided reports on overall status of fund and types of benefits provided.	n. a.	n. a.	n. a.

Shares include equity investment in sponsoring company. n. a. = not available.
Source: *Secretaria de Previdência Complementar, ABRAPP, and OECD (1998,1999)*

Regulations on fiduciary responsibility in Brazil are mostly aimed at avoiding conflicts of interest between pension funds and related entities and include a set of constraints for pension fund administrators, including prohibiting fund administrators to: (i) reveal confidential information about investment decisions; and (ii) chose directors of private companies that are linked to the administrator. Finally, regulations contain rules and conditions for the selection of pension fund administrators to ensure that their sole objective is managing the fund as well as possible.

Mutual funds. In most countries, mutual funds are highly regulated entities. Regulations are mostly aimed at protecting the interest of mutual fund investors and the integrity of their investments. The most significant regulations are (i) asset valuation and certification of financial statements; (ii) disclosure of information to investors; (iii) legal structure of funds including governance mechanisms and (iv) safe custody of assets. While over the last few years, many of the regulations in Brazil have been brought largely in line with international best practice, the increased importance of mutual funds requires a careful review of the legal structure and regulatory framework under which they operate to ensure that it is in line with international best practice. In addition, the structure of institutions involved in the regulation and supervision of mutual fund needs continued review. For historical reasons, related to periods of macro instability, fixed income funds are currently regulated by the Central Bank, for example, whereas equity mutual funds by the CVM. This has created the possibility of different rules and the potential that funds are supervised differently. The government is planning to move the regulation and supervision of all mutual funds to the CVM, but, in contrast to almost all other markets, there remains a large role of the central bank in the regulation of fixed-income instruments and funds.

Legal structure of funds. International experience indicates that fund industries work best when funds are required to be structured in such a way that there are checks and balances providing an adequate amount of private supervision over fund managers. While Brazil is currently relying on self regulation by brokers and dealers and their obligation to apply good faith/prudent rule, international experience indicates that self-regulation has limited potential in this type of industry. Fund managers, unlike broker/dealers, do not depend on transactions among themselves and hence do not have the same incentives to establish and enforce rules of good behavior. Taking into account the limited capacity of the securities markets' supervisor, funds should be required to be legally organized as corporations, with independent boards of directors responsible for monitoring behavior of management to maximize private oversight and checks and balances. If mutual funds are organized as corporations, investors become shareholders and should have, like shareholders of other companies, specific voting rights including electing directors at a meeting, and approving material changes in the terms of a funds investment advisory contract. Typically, to provide directors with proper incentives to monitor the funds' activities, directors should be made liable and shareholders should be able to take them to court if they do not fulfill their "fiduciary" duty. Finally, to further safeguard shareholders, at least one third of the directors should be independent of the fund's investment adviser and others closely affiliated with the fund. As companies, funds would be subject to normal annual shareholder meeting, auditing and accounting requirements. And, of course, custodians independent from the funds managers would be responsible for safekeeping of fund assets.

Safeguards against potential conflicts of interests. To protect against potential conflicts of interests, banks should have to clearly separate their commercial and investment banking activities from their investment management activities, both pension fund and mutual fund management, through "Chinese walls" and separate management structures. While Brazil mandated Chinese walls between a bank's investment management and other activities in June 1998, it suspended the application of this regulation for a number of banks, including some public banks. Given the large potential for conflicts of interests, the Chinese wall requirement should be reinstated for all institutions and strictly enforced. Moreover, financial institutions should be required to establish internal compliance units to assure that rules against conflicts of interest are being adhered to. Finally, employees of investment management departments should not be allowed to work in any other part of the financial institution.

Role of mutual and pension funds in the corporate governance of corporations

Stock mutual funds are relatively small in Brazil and do not actively play a role in the corporate governance of operations. While this also holds for the smaller closed-end pension schemes, the larger public pension funds, because of their size, often have representations at the Board of Directors and thus can play an important role in the governance of corporations. Pension funds also have become large owners in privatized utilities (e.g., Telebras). This is especially the case for public employer sponsored closed funds. As Table 17 shows, the closed fund of Banco do Brasil, Previ, for example, has been a large player in recent privatizations. Institutional investors can be important forces to monitor the behavior of inside investors and improve corporate governance. In European countries, for example, other large shareholders mitigate the degree of expropriation by controlling shareholders.[42]

Yet, pension, and to some degree, mutual funds can only properly exercise their own role in the corporate governance of corporations in which they have substantial ownership if they themselves are properly managed and have adequate incentives to maximize risk adjusted return on pension fund assets. And, as laid out above, there is still significant room for improvement in this area.

Table 17. Closed pension funds share of issues in privatizations

Share of total equity offerings taken up by particular fund and all closed funds

Privatized company	*Previ*	*All closed funds*
Usiminas	15.0	26.1
Acesita	15.0	36.1
Embraer	9.8	29.5
Tecon (CODESP)	20.0	35.0
Tele Centro Sul	19	N/A
Telemig Celular	18	N/A
Tele Norte Celular	18	N/A
Área 7 Americel	N/A	39.0
Área 6 Telet	N/A	41.0

Public sector investors (including development banks, state-owned commercial banks, BNDESPAR and state-run pension funds) generally do not have the same incentives for carefully policing the performance and accountability of their investees. At the same time, they can serve as champions of transparency, standard-setting and voluntary compliance. This practice is being exercised by public-sector employee funds in the US, such as California Public Employees

[42] Mara Faccio, Larry H. P. Lang, and Leslie Young, "Dividends and Expropriation," mimeo Hong Kong University.

Retirement System (CALPERS). In Brazil, funds such as PREVI could become the leading champions for corporate governance improvements. Over the medium term, Brazil should curb the state involvement in financial intermediation, and leave those with a real stake in company performance to police their own investments. In the meantime, agencies like BNDES and BNDESPAR can put in place policies to encourage investees to meet minimum objective criteria (such as those set out in codes of best corporate governance practice). These policies can include focussing investments on companies that comply with minimum—and objectively determined—corporate governance standards, or bars against investment in companies that do not meet these criteria. This is being practiced in other Latin American countries. The Chilean pension fund scheme, for example, requires that companies meet certain voluntary corporate governance criteria before they can be eligible investments for pension funds' investments.

IV. Taxes and Transaction Costs

High taxation. Taxation of capital market transactions is very high in Brazil, with the major tax the provisional contribution on financial transactions (Contribuicao provisora sobre movimentacao financeira, CPMF), enacted by Congress at end 1996. The contribution is levied at a rate of 0.38 percent (raised in January of 1999 from 0.2 percent) on every financial transaction. The contribution is collected in cascade (cumulatively) by financial institutions. While taxes on securities transactions vary in terms of nature, size and implementation across countries (Table 20, column 2 & 3), most OECD countries have either reduced or abolished such taxes over the 1990s (for example, Germany and Japan had abolished existing taxes by the end of 1999). Compared to countries that still have transaction taxes, Brazil's taxes are relatively high (see Table 18).

As the CPFM is applied across all types of securities, investors cannot evade the tax by trading substitute securities with similar pay-off structures. But, transactions involving transfers of funds from one legal entity to one another are excluded. For example, investments in mutual funds are taxed, but movements of funds between mutual funds and mutual funds themselves are not. The tax thus does create incentives to reduce tax liabilities. Investors can, for example, evade the tax by using mutual funds as a trading vehicle. And, investors can change the location of the trade, moving transactions off the exchange or abroad, adversely affecting trading volume locally. The most important effect on capital markets development is that, in order to reduce their tax liability, investors choose not to trade. The reduction in trading activity can be quite significant: in case of the UK in the mid-1990s, it has been found that the overall liquidity of traded securities may have increased by about 70 percent if the tax was lowered from the then 2 percentage points to 1 percentage points (with long-run elasticity of 1.65).[43] Cross-country work confirms the effect of trading costs on liquidity.[44]

[43] Campbell and Froot, 1995.

[44] For a sample of 42 countries, Domowitz, Glen and Madhavan, 2000b show that turnover is inversely related to overall transaction costs (including both direct costs such as commissions and fees as well as market impact costs, including the spread), with an elasticity of about 0.6.

Table 18. Transactions Taxes around the World

Country	*Tax Size 1991*	*Description*	*Notes*	*Changes Since Taxes 1998*
Australia	0.3%	Transaction tax	Additional stamp tax removed in 1991	
Austria	0.15%	Transfer tax	May be avoided by trading of exchange	Lowered to 0.15%
	0.06%	Arrangement fee	May be avoided by trading off exchange	
	0.04%-0.09%	Courtage fee		
Belgium	0.17%	Stamp tax on buys and sells	No tax ex country; maximum of 10,000 Belgian francs	Bonds 0.07% Trans. Certificates 0.07%
	0.025%	Stock market fee		
Brazil	**0.38%**	**Provisional contribution on financial transactions (CPMF)**	**Enacted in 1996 to fund the public health system. Contribution is levied on every transaction with few exceptions.**	**Raised from 0.2% to 0.38% in January of 1999, to be lowered over time**
Canada		No taxes		
Denmark		No taxes for nonresidents		Abolished in October 1999
Finland	0.5%	Transaction tax	Waived if both parties are foreign.	Eliminated in 1992
France	0.15%	Trading tax	Tax on trades>1 million francs, rate is doubled on smaller transactions, may be avoided by trading ex country	Stamp duty on French securities for French individual investors
Germany	0.12%	Boersenumsatz Steuer	Residents only	Taxes removed
		Courtage tax (official broker fee)		
	0.06%		Tax may be avoided by trading ex country	
Hong Kong	0.25%	Stamp duty		Stamp duty reduced to 0.125%
Italy	0.06%	Courtage tax		
Japan	0.30%	Sales tax	May be avoided by trading ex country	Taxes removed
Malaysia	0.05%	Clearing fee	Maximum $100; may be avoided by trading off exchange	
Netherlands		No taxes		
New Zealand	0.0057% plus per trade fee	Transaction levy	May be avoided by trading off exchange; eliminated in 1992	Taxes abolished
Norway		No taxes		
Singapore	0.1%	Contract stamp duty	May be avoided by trading off exchange	Reduced to 0.05%
	0.05%	Clearing fee	Maximum S$100, may be avoided by trading off exchange Purchases only; eliminated in 1992	Abolished goods and services tax 3% on transfer fees
	0.02%	Transfer stamp duty		
Sweden	0.05%	Turnover tax	Tax may be avoided by trading ex country	Eliminated
Switzerland	0.0005%	Exchange fee	Tax may be avoided by trading ex country	Eliminated
	0.01%	State tax	Tax may be avoided by trading ex country	
	0.075%	Stamp tax	Tax may be avoided by trading ex country	Stamp tax 1.5% for foreign security
United States	0.0033%	SEC fee		
United Kingdom	2 pounds	Levy	On trades over £5,000	Levy abolished
	0.5%	Stamp duty tax	On purchases only	

Source: FIBV, CVM, and IOSCO.

A reduction in turnover taxes will have to take into account the overall fiscal situation. The CPMF is an important contributor to overall fiscal revenues: in 1999 it accounted for 7% of total revenues of the federal government. The tax is to be phased out in steps over the next five years,[45] which should help increase liquidity over time. More generally, the taxation of financial transactions in Brazil varies by type of instrument, issuer and investor, and as such is subject to many distortions, potentially also hindering its capital market development. An in-depth evaluation and reform of financial taxation could help capital market development.

And trading costs compare unfavorably to international financial centers. Table 19 provides the average all-in costs for a foreign institutional investor of buying or selling across a number of Latin American emerging markets, and the UK (as noted, foreign investors are not subject to the CPMF). The all-in costs (commissions, taxes, ticket and spread) in Brazil exceed those in Argentina, Mexico and Peru, and are about 50 basis points higher than those in the UK. Much of higher cost in Brazil compared to other Latin America is due to the high spread in the Brazil market. The consolidation in trading systems underway allows for an opportunity for reducing costs, although the gains of consolidation itself will likely be small as already 95% of trading occurred on BOVESPA. Furthermore, complementary measures involving, among others, the consolidation of the brokerage industry, are also necessary. More importantly, the direct trading cost in Brazil, as in most Latin American countries, compares unfavorable to those in the US where direct costs are only 8.3 basis points.[46] Since Brazil time zone largely overlaps with that of the US, it is particularly vulnerable to trading migration.

Table 19. Transaction costs in Brazil and other markets

(for a foreign institutional investor)

	Argentina	***Brazil***	*Chile*	*Colombia*	*Mexico*	*Peru*	*Venezuela*	*UK*	*US*
Commissions and taxes	0.43%	0.25%	1.04%	0.63%	0.25%	0.59%	1.09%	0.45%	0.083%
Ticket	0.04%	0.04%	0.06%	0.10%	0.02%	0.11%	0.09%	0.01%	NA
Spread	1.15%	1.41%	1.05%	1.84%	0.81%	0.83%	0.64%	0.63%	0.30%
Total	1.57%	1.63%	2.09%	2.47%	1.06%	1.42%	1.74%	1.09%	0.38%

Note: For Brazil, costs do not include the CPMF.
Source: State Street.

High cost lead to migration of trading and new capital issuance. Without a reduction in costs, a (even) larger share of trading and new issuance will migrate abroad as the listing and trading on foreign stock markets has many benefits for Brazilian corporations, especially larger ones. The migration of Brazilian corporations has been particularly strong into ADR Programs listed in New York. As Table 20 demonstrates, foreign portfolio investment always played an important part in the Brazilian equity market. Foreign portfolio investors now account for over 22% of Brazilian market

[45] In June 2000, it was reduced to 0.3 percent and in 2001 further to 0.2 percent.
[46] Average one-way equity trading costs in basis points for active managers in 42 countries in the period September 1996-December 1998 based on quarterly data provided by Elkins/McSherry Co., Inc Source: Domowitz, Glen and Madhavan, 2000b.

capitalization, and represent a much higher level of the real public float and trading volume.

Table 20. Foreign portfolio investment[a]

	1996	*1997*	*1998*	*1999*
No. of Companies listed on BOVESPA	550	536	527	478
Market Capitalization US$ billion	216.9	255.4	160.9	228.5
Foreign Portfolio Value[b] (%)	26.72	32.07	17.52	23.26
No. of ADR/GDR Programs	41	50	65	71
Value of ADR/GDRs US$ billion	n. a.	n. a.	14.31	27.58

Note: [a] Year end figures; [b] Annex II and Annex IV Portfolios. n.a.= not available.
Source: CVM, Monthly Report.

But the growth in ADRs has been much stronger than that of inward foreign portfolio investment and in 1999 the value of ADRs exceeded foreign portfolio investment in domestic shares. This trend can be expected to continue and perhaps accelerate. The number of Brazilian ADR programs has steadily increased from 41 companies at year-end 1996 to 71 at the end of 1999 and 76 today (see Table 20). These firms have a market capitalization that amounts to about 20% of the total market capitalization of BOVESPA, a significant migration. Indeed, in March 2000, trading volume in Brazilian shares in the US ADR market exceeded the trading volume in the BOVESPA.[47] Following the Mexican pattern beginning earlier in the decade, shareholding and trading in ADRs is progressively replacing transactions in the domestic market.

Table 21 is indicative of the migration into ADR programs over the last four years. In most cases, there is a steady progression out of the domestic market into ADR programs with often more than 50% of non-voting shares in ADR programs. The shares of newly established telecommunications companies have followed a similar pattern, rising from an average of 54% of PN shares in the program three months after establishment of the programs in September 1998 to over 60% (and in one case almost 70%) at year-end 1999.

[47] Bank of New York statistics.

Table 21. ADR Programs of Brazilian Issuers
(percentage of non-voting shares in ADR programs)

	Yr. Program *Established*	*1996*	*1997*	*1998*	*1999*
Aracruz	1992	33.41	50.10	53.35	55.81
Brahma	1995	1.11	15.29	19.77	36.41
Electrobras	1994	17.50	19.20	18.97	5.77
Petrobras	1996	0.89	8.06	12.17	20.31
Telebras	1992	42.88	50.72	55.31	64.45
Unibanco	1997			28.55	32.37
CRVD	1994	12.99	19.59	23.86	32.74

Note: Year end figures.
Source: Bank of New York.

The Brazilian ADR and trading migration is reflecting global trends. ADRs are an increasingly popular instrument globally and in 1999 US$533 billion in depositary receipt trades were recorded on the NYSE alone. When firms from emerging markets use ADRs/GDRs or list on the US equity markets, evidence shows that their financing constraints are relaxed (in the sense that their sensitivity of new investment to internal cash flow is reduced).[48] Also, domestic firms that participate in international markets obtain better financing opportunities and extend their debt maturity.[49] Listing abroad is also a tool for corporations to signal to their investors that they are more willing to protect minority rights as corporate governance rules are stronger abroad. Empirically, corporations from weak corporate governance environments are more likely to (cross-) list abroad.[50] Furthermore, evidence suggests that by raising bonds abroad (in the US), corporations certify to act in the interest of investors and thus lower their borrowing costs and increases shareholders' wealth.[51] This appears to be particularly the case for Brazil as it was, after Mexico, the country with the largest number of firms (21) raising debt financing through 144A issues in the US.[52] And trading is typically much more liquid in foreign markets relative to local markets. It has been documented, for example, that Mexican stocks with ADRs see more trading in New York than in the local market, with mixed benefits for various classes of investors.[53] Similar effects appear to be occurring in case of Brazil.[54]

All of this is to say that Brazilian capital markets are at a disadvantage relative to international markets for the trading and issuance of securities, especially for the better credit firms. With the removal, regulatory and otherwise, of many outward (as well as inward) bound restrictions on portfolio flows, corporations will have greater opportunity to access foreign markets. Corporations interested in improving their corporate

[48] See Lins, Strickland and Zenner, 1999.
[49] Sergio Schmukler, 2000, mimeo, World Bank and Chaplinksy and Ramchand, 1999.
[50] Reese and Weisbach, 2000.
[51] Darius P. Miller and John Puthenpurackal, 2000.
[52] Chaplinksy and Ramchand, 2000.
[53] See Domowitz, Glen and Madhavan, 1998, for the case of Mexico.
[54] See for example, Eucherio Lerne Rodrigues, 1999, CVM.

governance, and signaling that to external financial markets, to lower their costs of capital will not wait for the improvements in the domestic markets. At the same time, many smaller firms are entering as they are taking over foreign firms or go private. This puts all the more pressure on local markets to improve, and making reform all the more necessary.

The two trends—migration to ADRs and exit of multinational- and family-controlled companies—means that local capital markets become less attractive for already-established industrial sectors. Larger and more established enterprises already have strong presence in the international capital markets (either through ADRs or their parent companies) and are likely to continue to look to these markets to meet their needs (at lower cost). Rather, newer enterprises with comparatively modest capital requirements should aim to meet their medium-term financing needs domestically. This has implications for institutional development (including the greater need for market makers, underwriters, serious market research and analysis, perhaps a more quote-driven market) as well as marketing strategy. The experience with small-capitalization markets in Latin America is mixed, at best. Technology companies worldwide have favored US markets (Israel is a good example).[55] Lowering the standards of the domestic capital markets to attract new firms to list does not work necessarily as a way to boost capitalization and trading. Mexico's experiment with a small capitalization market (MEMMEX) failed. But perhaps Brazil's larger size and economic diversity would make it more viable.

[55] See also Pagano, Roell and Zechner, 1999 who show that high-tech, European pursuing a strategy of rapid expansion tend to cross-list in the United States.

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Annex: Detailed Regression results

Using data for 601 corporations in 13 countries, including, besides Brazil, Australia, Canada, Denmark, Finland, Germany, Hong Kong, Norway, South Africa, Sweden, Switzerland, UK, and the US, we try to explain the voting premium, the price of voting share relative to non-voting shares, on the basis of institutional differences, and controlling for firm characteristics. More detailed results are in Nenova, 2000. The indexes used for the quality of investor protection are described in Annex table 2.

Annex Table 1. Average premium for voting shares

Explanatory factors	*Regression 1*	*Regression 2*
Constant	31%	-19%
Quality of investor protection	-20%	-18%
Quality of takeover laws	-4%	4%
Strictness of charter regulations	5%	4%
Concentrated ownership	-10%	-13%
Concentrated ownership squared		0%
Size	0%	-5%
Excess dividend	-5%	-2%
Liquidity	-7%	30%
Number of observations	601	601
R-squared	0.3531	0.5656

The regression results can be used for a policy experiment to infer what changes in the legal environment might imply for the case of Brazil. The average premium for voting shares, adjusted for size, dividend, liquidity and other differences, is 23 percentage points. If the quality of investor protection went from actual to the highest possible level, the average premium for voting shares will decrease by 10.7 percentage points. Similarly, if the quality of takeover laws went to the highest possible value, the average premium for voting shares will decrease by 9.26 percentage points. In other words, the poor quality of investor protection explains 54% of the average premium for voting shares, and the poor quality of takeover laws explains 46%. The effect of charter regulations and concentrated ownership is minimal. Note: the calculations above use a concentrated ownership dummy, instead of the continuous ownership variable which is used in the reported regressions.

Annex Table 2. Description of legal environment variables

Variable	*Description*
Investor protection enforcement	Product of the two legal indices used in La Porta et al. 1998. The index of investment protection rights aggregates proxy by mail dummy, shares block dummy, cumulative voting dummy, oppressed minority dummy, preemptive right dummy, and the percentage required to convene an ESM. Ranges from 0 to1. The index of quality of law enforcement aggregates efficiency of the judiciary, rule of law, and corruption. All variables are scaled from 0 to 1 before averaging (1 being good investment protection or enforcement). Source of components: La Porta et al. 1998
Quality of takeover laws	Sum of three indexes: Comparable treatment rule =1 if the legal code requires a control contestant to treat all classes of shares in a "fair and equitable" manner. Mandatory offer rule =1 if the legal code requires a dominant vote-owner to make an open market bid for all shares after reaching a certain level of firm ownership. Fair price rule =1 if the legal code requires a buyer of a large or majority block, if also purchasing minority shares, to pay minority shareholders the same price as for the block shares
Charter provisions	Sum of charter rules indexes: Voting caps =1 if the firm has placed an upper limit on the votes that a single shareholder can cast; Coattail provisions =1 if the firm has a charter provision that the limited-voting shares become convertible into multiple-voting at the time of a control change; Gold shares =1 if the firm has given special decision-making rights to a shareholder or a shareholder group, that are unavailable to dispersed shareholders; Limits to the transferability of shares =1 if the firm has discretion over who can enter its shareholder register; Enhanced voting power in board elections for the limited-voting class, relative of that class' voting rights =1 if the limited-voting class elects a larger share of directors than its share of the voting power suggests; Enhanced voting power for the limited-voting class conditional on dividend non-payment or other contingencies =1 if the firm has a charter provision that limited-voting shares get more votes in case of dividend non-payment, sale of assets, or when the multiple-voting shares cross for concentration threshold of too high voting power relative to their share of cash flows.