

BRAZIL

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SUMMARY

The Brazilian Securities and Exchange Commission (Comissao de Valores Mobiliários, or CVM) and the Central Bank of Brazil regulate Brazil's securities markets.

The Sao Paulo Stock Exchange (BOVESPA), the largest of Brazil's nine exchanges, has registered impressive gains in both volume and share appreciation in recent years, but market capitalization as a percentage of GDP remains low. Nonetheless, the total value of shares traded on the BOVESPA market is equal to approximately 60 percent of market capitalization for all of South America as of March 1998. Market valuation and volume almost doubled in the first half of 1997 before the initial onset of the Asian financial crisis began to affect prices.

The market for new domestic issues remains thin as few corporations choose to raise capital through the Brazilian bourse. Having obtained permission to offer securities and place commercial paper abroad, larger Brazilian firms have gravitated toward international markets in order to raise capital as they have been able to obtain funding more cheaply and flexibly than is possible in the domestic financial market. In particular, the number of American Depositary Receipt (ADR) offerings has increased significantly in recent years.

Free from forced separation of the banking and securities businesses, the primary participants in the Brazilian securities market are multiple or universal banks, followed by large public and private pension funds and mutual funds. Other types of banks may conduct securities business through a subsidiary after obtaining pro forma approval from the CVM's National Monetary Council. With respect to foreign participants, Article 192 of the Constitution of 1988 barred all new entry of foreign securities and brokerage firms, but foreign firms established prior to that time were permitted to remain. A transitional rule provides for exceptions on the basis of national interest, obligations under international agreements, and reciprocity. It is expected that passage of a so-called Complementary Law to the article will clearly provide for new foreign entrants and the increase of existing investments. Foreign firms established here prior to 1988 may underwrite, broker, and trade in domestic securities and may also hold seats on Brazilian stock exchanges. They face no other impediments to doing business in Brazil. New foreign firms have entered the Brazilian securities market primarily as minority partners in joint ventures with Brazilian companies.

Since 1991, the government has been changing regulations to facilitate foreign portfolio investment in Brazil. Particularly important was approval in that year of Annex IV, which opened Brazil's stock market significantly by permitting foreign institutional investors to invest directly via managed portfolios and eliminating diversification requirements and the minimum holding period before repatriation. Since implementation of Annex IV, the net inflow of foreign portfolio investment rose

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from US\$1,704 million in 1992 to US\$6,415 billion in 1997. From 1992 to 1997, cumulative net portfolio investment inflow totaled US\$31 billion.

DESCRIPTION OF THE MARKET

Regulation

Brazil's National Monetary Council, which is formally chaired by the Minister of Finance and also includes the chair of the Central Bank and the Minister of Planning, is the highest federal government regulatory body overseeing the securities markets. The Central Bank is the primary executing authority for all Council decisions and the President of the Central Bank is a member of the Council. The Council sets guidelines for the securities industry that are implemented by the Brazilian Securities and Exchange Commission (Comissao de Valores Mobiliários, or CVM), the equivalent of the U.S. Securities and Exchange Commission. The CVM has a staff of 380, is administered by a chair and four commissioners, and is linked to the Finance Minister. The CVM also regulates futures trading in stocks and stock indices.

Law 6385, enacted in 1976, empowers the CVM to supervise the activities and services of the securities markets and to impose fines as punishment for infractions. The CVM regulates stock exchanges, brokers, and equity mutual funds and also supervises pension fund and leasing company activities in the stock market. CVM authorization is required before securities exchanges can start operations. Foreigners may purchase domestic shares via both direct investment and portfolio investment made by institutional investors through the managers of the respective portfolios (Annex IV). Depositary Receipts such as ADRs are another method of acquiring shares via foreign stock exchanges and provide a mechanism for the placement of Brazilian shares in international markets. Portfolio investment by foreign investors in fixed-income instruments is restricted to two classes of fixed-income funds.

The Central Bank of Brazil regulates bond mutual funds, commodity, interest rate, and foreign currency futures, pension funds, leasing companies, and investment abroad by Brazilian individuals and firms.

Capital Formation: Instruments and Exchanges

High inflation prior to the 1994 Real Plan and persistent government budget deficits since have left a large supply of Brazilian government paper in the hands of the private sector. As a result, Brazilian government paper remains the primary instrument traded by financial institutions, especially after the doubling of reference interest rates in October 1997. Most of this paper is short-term in nature and is therefore popular both for its high liquidity and positive real rates of return. Investors participate through government-certified dealers (primarily banks, both domestic and

foreign) in the Central Bank primary government paper market. The most important public debt instruments are National Treasury Notes (NTN), Central Bank Bonds (BBC), National Treasury Financial Letters (LFT), and National Treasury Letters (LTN).

Debt instruments vary by maturity, purpose (debt finance or monetary policy), and indexation to exchange or interest rates. The percentage of inflation-indexed bonds declined dramatically with the success of the Real Plan stabilization. Both the Treasury and the Central Bank issue domestic currency bonds indexed to the real/dollar exchange rate: National Treasury Notes-Dollar (NTN-D) and Central Bank Notes-Exchange (NBC-E), respectively. As of December 1997, the stock of federal securities outside of the Central Bank stood at US\$229 billion and those of states and municipalities in private hands at just over US\$10 billion.

Brazil has nine stock exchanges, listing a total of 590 companies. (Dual listing is permitted.) The largest, representing over 90 percent of total trading volume, is the Sao Paulo Stock Exchange, BOVESPA, which trades in stocks, including stock options and futures. The Rio de Janeiro Stock Exchange (BVRJ) accounts for about five percent of volume. The seven other regional exchanges have a negligible presence and are linked electronically with the Rio exchange.

BOVESPA's relative importance is explained in part by the shift in economic activity, particularly industrial, from Rio de Janeiro to Sao Paulo in recent years. Recently, other states have been increasing industrial activity as well by offering fiscal incentives to foreign companies, especially in the automotive sector.

BOVESPA listed 536 companies in December 1997, down from 552 in 1993. Nationally, the trend has been to delist on stock exchanges: 618 in 1980 to 582 in 1993 to 590 in 1997. Some companies choose to delist (or “close capital”) because of balance sheet publishing costs (“custo de divulgação”). For example, a company may choose to raise funds through loans instead of stocks or debentures to free itself from the mandatory requirement of publishing its balance sheets.

Daily turnover provides a rough comparison of the relative sizes of Brazil's exchanges.

Brazilian Stock Exchanges	
(Volume in US\$ thousands, cash market, 1997)	
Sao Paulo	154,879,924
Rio de Janeiro	9,138,338
Minas-Espirito Santo-Brasilia	960,194
Pernambuco and Paraiba	473,676

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Brazilian Stock Exchanges (Volume in US\$ thousands, cash market, 1997)	
Parana	227,948
Regional	144,922
Extremo-Sul	3,940
Bahia-Sergipe-Alagoas	2,604
Santos	1,037

Source: National Commission of Stock Exchanges

The increase in market capitalization on the BOVESPA bourse has been remarkable in the last few years, rising from US\$99 billion in December 1993 to US\$255 billion in December 1997. However, market capitalization as a percentage of GDP remains relatively low at 32 percent. Furthermore, while overall performance has been impressive, year-to-year changes have been erratic. The BOVESPA stock index rose 60 percent in 1994, fell 14 percent in 1995, rose 53 percent in 1996, and was up 34 percent in 1997 in U.S. dollar terms. After rising 20 percent in the first four months of 1998, the market had lost all of its gains in the next two months. An important reason for recent volatility is the high degree of liquidity in the Brazilian stock market compared to other emerging market exchanges. When investors become nervous about emerging markets, as has occurred since July 1997, the Brazilian exchange is often the first to be tapped in order to increase portfolio liquidity.

Few corporations raise capital through the Brazilian exchanges due to the considerable expense involved. In 1993, only US\$841 million was raised in the primary market, generated through 24 new issues. In 1997, comparable figures were US\$3.5 billion and 23 new issues. Efforts to expand opportunities for capital formation are ongoing. In particular, privatization of state enterprises has been increasing activity in the market due to share offerings by the new owners and to the creation of new issues via the breakup of public enterprises, especially in the power and telecommunications sectors. Brazilian firms are allowed to offer securities on international capital markets via Depositary Receipts and obtained permission to place commercial paper internationally in mid-1990. The latter funding mechanism has been widely used by larger firms as it is a much cheaper source of finance in view of the high real interest rates and short maturities which characterize domestic lending.

Trading volume in the secondary market in 1997 was US\$216 billion. Equity trading on Brazilian exchanges is highly concentrated in a handful of stocks, mainly public sector firms. Although 590 companies were listed on all Brazilian exchanges as of December 1997, telecommunications parastatal Telebras accounted for almost 60 percent of volume and electric utility parastatal Electrobras for almost 4 percent. Government petroleum monopoly Petrobras accounted for another four percent.

The Commodities and Futures Exchange (Bolsa de Mercadorias & Futuros, or BM&F) came into being as a result of the May 1991 merger of the traditional Bolsa de Mercadorias de Sao Paulo (SP Commodities Exchange) dating back to 1917 and the Bolsa de Mercadorias & Futuros created in 1986 which had a greater number of financial operations in derivatives. On June 30, 1997, BM&F merged with Rio de Janeiro's BBF (Bolsa Brasileira de Futuros, created in 1983), resulting in the principal derivatives negotiation floor within Mercosur.

BM&F's clearinghouse is to operate electronically as a division. According to BM&F, this model appears more suitable for the Brazilian derivatives market than hiring an independent company to provide the service. In addition, there is a comprehensive guarantee system composed of funds for liquidating operations, reducing delinquency, etc.

A large number of items can be traded in the BM&F via its various markets as futures, puts, calls, swaps, spot, and term. Among these products are the BOVESPA index, C bonds (Brazilian Brady bonds), the U.S. dollar, the overnight interest rate, and commodities, such as gold, soy, crystal sugar, cotton, "fat ox," arabica coffee, and corn.

Participants

In contrast to the United States, Brazil has not traditionally segregated participation in the banking and securities markets. A new "Chinese Wall" regulation due to take full effect as of July 1998 would require banks to segregate management of third party funds from bank treasury operations, however. In fact, the primary players in the Brazilian securities markets are the so-called multiple banks, both domestic and foreign, which account for 40 percent of trading volume. Multiple banks are authorized to provide a broad variety of financial services including investment and commercial banking, stockbroking, and leasing. Other major participants include the large public and private pension funds and mutual funds. Foreign investors as a group account for some 26 percent of trading volume. While more individual investors have been entering the market via mutual funds, particularly since the beginning of 1997, individual investing remains relatively insignificant.

Securities Held by the Public (US\$ billions, as of June 1998)	
Government Paper	229.0
<i>of which: Central Bank</i>	<i>58.4</i>
<i>Treasury Notes</i>	<i>170.6</i>
Certificates of Deposits (balance)	105.6

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Securities Held by the Public (US\$ billions, as of June 1998)	
Government Paper	229.0
Savings (balance)	174.0
Mutual Funds (fixed income, net worth)	113.9
Mutual Funds (foreign capital, net worth)	4.2
Social Development Funds (net worth)	0.4

Source: Central Bank and ANDIMA (estimates)

Brazil has two classes of stockbrokers: corretoras and distribuidoras. Corretoras are securities firms that hold seats on the exchanges. Distribuidoras accept trading orders from investors and deal indirectly with the exchanges through the corretoras. A seat on an exchange must be purchased in order to establish a brokerage firm. Both foreign and domestic firms may function as either corretora or distribuidora. For firms established prior to 1988, no restrictions are imposed in opening a corretora or distribuidora. Firms which entered the Brazilian market after 1998 can also purchase a seat on a stock exchange through an exemption to Article 52 of the Transitory Constitutional Provisions Act. The top 40 brokers accounted for four-fifths of total trading in December 1997.

Brazilian Mutual Funds May 1998	
Type	Number
Stock Funds	106
“Carteira Livre” Funds	453
Foreign Capital Investment Funds	13
Foreign Capital Conversion Funds	21
Foreign Capital Fixed Income	105
Fixed Income Funds: Short-Term	92
Fixed Income Funds: 30-day	109
Fixed Income Funds: 60-day	1,057
Fixed Income Funds: 90-day	100
TOTAL	2,056

Source: Central Bank of Brazil

Capital Controls and Foreign Investment

Foreign portfolio investment is subject to the exchange control system established by the Foreign Capital Law. As of December 1997, the government had authorized nine vehicles for foreign portfolio investment:

- Annex I: Investment Companies
- Annex II: Open-end Funds
- Annex III: Closed-end Funds
- Annex IV: Institutional Investment
- Annex V: American Depositary Receipts
- Foreign Capital Privatization Mutual Funds
- Foreign Capital Conversion Mutual Funds
- Foreign Capital Emerging Companies Mutual Funds
- Foreign Capital Fixed Income Mutual Funds

(Individual portfolio investment is also possible via so-called “CC-5 nonresident accounts.”)

Brazil's regime of capital controls has been significantly liberalized in the 1990s. Starting in 1991, a number of regulations were changed to facilitate foreign portfolio investment in Brazil. In order to provide additional investment vehicles for foreign investors, beginning in 1991 the Brazilian authorities permitted foreign investors to invest in the country via American and Global Depositary Receipts (ADRs and GDRs), securities issued abroad based upon Brazilian shares deposited with a fiduciary institution.

Also in 1991, the National Monetary Council approved Annex IV, which significantly opened up investment in the stock market by permitting foreign institutional investors to invest directly through managed portfolios and eliminating the minimum holding period before repatriation. (Individual foreign investors and companies domiciled abroad can enter Brazilian stock markets through Annex II, but are ineligible for the capital gains tax exemption granted to Annex IV investors.) In addition, Annex IV permitted establishment of omnibus accounts to incorporate sub-accounts of other institutional investors. Omnibus accounts permit foreign investors to set up individual accounts, thus circumventing restrictions on foreign individual investors directly investing in the Brazilian securities market.

Rules allowing swaps were established in 1994. Foreign capital fixed-income funds may conduct operations in organized derivatives markets, including futures operations carried out in markets managed by stock exchanges or commodities and futures exchanges. Subject to certain conditions and Central Bank oversight, Brazilian private sector entities may engage in hedging operations with financial institutions or stock exchanges abroad to protect themselves against the risk of variations in interest rates, exchange rates, and commodities prices.

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Brazilian firms may hold equity shares in foreign companies, subject to regulation by the Central Bank. Companies or individuals may make investments through the purchase on Brazilian stock exchanges of custody certificates representing issued shares. Brazilian firms may send up to US\$5 million per year abroad to related companies to pay for offices, service centers, and representatives without previous Central Bank approval. However, the transaction must be reported to the Central Bank. Firms may also send more than US\$1 million abroad provided that the bank carrying out the transaction consults with a Central Bank regional office 30 days in advance and the Central Bank has no objection. Upon closing down business activity abroad, a Brazilian firm is required to repatriate capital and any receipts.

Foreign investors may make indirect portfolio investments in Brazilian equities by acquiring shares in an Annex I Brazilian investment company (not quoted on exchanges) or an Annex III Brazilian investment company (quoted on the New York Stock Exchange).

Since implementation of Annex IV, annual net foreign investment in the Brazilian market increased from US\$386 million in 1991 to US\$5.5 billion in 1993 before dropping to US\$1.6 billion in 1997 due to the Asian financial crisis. For the first quarter of 1998, net inflow was US\$2.2 billion. According to BOVESPA, foreign investors account for some 26 percent of trading volume. As of December 1997, the CVM had registered two foreign investment companies, 15 open-end investment funds, one closed-end fund, and 455 Annex IV foreign investors. The last category included 217 banks, 87 brokers, seven pension funds and 144 other investors. By origin, Annex IV investment was 31 percent North American, 36 percent Central American, 22 percent European, 9 percent South American, and 2 percent Asian as of December 1997. Of some US\$32 billion in Annex IV investment in December 1997, 96 percent was in stocks and the remainder in securities: derivatives, debentures and privatization bonds.

Foreign investment other than portfolio investment in Brazil is classified for purposes of registration as direct investment or a loan. If the foreign capital does not constitute part of the corporation's capital directly subject to operational risk, it is considered a loan.

Foreign Participation in Financial Markets (US\$ millions)					
	1994	1995	1996	1997	1Q 1998
Investments	27,214	28,010	35,152	56,719	13,319
<i>of which: Portfolio</i>	21,600	22,559	24,684	37,190	8,519
<i>Direct</i>	2,241	3,285	9,580	17,864	3,171
<i>Mutual Funds</i>	3,373	2,166	888	1,665	1,629
Loans	8,756	15,883	28,078	35,535	19,218
<i>of which: Relending</i>	1,254	4,054	8,504	14,403	10,951
<i>Commercial Paper</i>	182	381	633	451	508
<i>Bonds and Notes</i>	5,961	9,650	18,046	20,448	7,615
<i>Export Securities</i>	261	494	297	58	144
<i>Renewals</i>	1,098	1,304	598	175	0
Financing	4,353	4,576	6,828	24,192	5,10
<i>of which: Registered</i>	630	1,074	1,422	12,131	4,488
<i>Authorized</i>	3,723	3,502	5,406	12,061	613
Leasing	842	1,143	1,868	4,002	365
Export Pre-pay	1,908	4,273	7,073	8,536	1,705
TOTAL	43,073	53,885	78,999	128,984	39,708

Source: Central Bank of Brazil

U.S. PRESENCE IN THE MARKET

Due to continuing high real interest rates domestically, Brazilian firms have sought increased access to foreign capital markets and U.S. securities and brokerage firms have played a leading role in

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assisting and advising them.

Several U.S. securities firms have minority interests in joint ventures with Brazilian companies. Salomon Brothers has been permitted by the Central Bank and CVM to gain a majority interest in a Brazilian securities firm by buying the shares of its Brazilian partners.

With respect to accessing foreign capital, U.S. securities firms have been very active in underwriting international issues by local firms. In an effort to lengthen maturities of private sector debt, the government has provided a fiscal incentive for maturities longer than eight years. The government has steadily increased its presence in the overseas debt market since 1994, mainly seeking to establish tenor and rate benchmarks for Brazilian private sector debt.

U.S. and other foreign banks have also been active in Brazil's securities markets. Citibank has its own brokerage operation and has a majority interest in the country's ninth largest brokerage house. U.S. and other foreign banks are well represented among foreign investment stock funds in Brazil.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Article 192 of the Constitution of 1988 effectively prohibited the entry or expansion of foreign banks and securities firms. Only those foreign securities firms already established in Brazil may underwrite, broker, and trade in domestic securities or hold seats on Brazilian exchanges. Despite these restrictions, foreign securities firms have been entering Brazil in recent years as partners of Brazilian firms.

Although no foreign or domestic firm had previously been permitted to deal in foreign securities, in September 1994, the Central Bank authorized Brazilians, via foreign and domestic banks, to invest in securities traded in international markets, with the proviso that 60 percent of the investment must be in Brazilian external debt.

Foreign firms may engage in fund management activities, although they may not sell foreign mutual funds to local investors. Foreign capital investment in Brazil remains subject to a number of exchange controls and other limitations on access, although repatriation is not restricted.

In WTO Financial Services negotiations held in December 1997, Brazil offered to provide national treatment in the financial services area, pending approval of the Complementary Law to Article 192. This law is currently awaiting congressional action and will liberalize entry into both the banking and securities sectors. In addition, further liberalization is subject to the provision that all members of senior management of financial services suppliers must be permanent residents in Brazil.