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Country Report: The Role of Institutional Investors in Promoting Corporate Governance in Brazil

To provide background for the development of an overview report on Institutional Investors and Corporate Governance in Latin America, the OECD asked consultants and task forces to elaborate country reports on current practices, challenges and prospects for improvement. These country reports are provided to the Roundtable participants as background for the meeting's discussion, and will be made available at http://www.oecd.org/daf/corporate-affairs/roundtables .

Brazil's report was elaborated by a task force integrated by representatives of the **Capital Markets' Investors Association (AMEC)**, the **National Association of Investment Banks (ANBID)** and the **Brazilian Institute of Corporate Governance (IBGC).**

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GOVERNANCE
PRACTICES ON ASSET MANAGEMENT
IN BRAZIL

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ANBID - National Association of Investment Banks
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1. INTRODUCTION

1.1 Participating entities

This report was prepared with the cooperation of three of the most important associations involved in the protection of minority shareholder rights, good governance practice and self-regulation of the investment funds market in Brazil.

AMEC - Capital Markets' Investors Association is the convergence of several independent portfolio management and those linked to financial institutions, that joined forces driven by the conviction that the current stage of development in the Brazilian capital markets required the existence, and provided the conditions necessary for the creation of an independent entity to represent the interests of fund investors as minority shareholders.

AMEC was conceived with the purpose of endowing the capital markets with the opportunity for coordination, discussion and execution of initiatives for defending investors' interests, above all fund investors in their relations with Brazilian publicly held companies.

Its members are convinced that the strengthening of the capital markets, which have consolidated into a modern instrument for financing the new cycle of self-sustainable development of the Brazilian economy, involves the respect and broadening of minority shareholder rights.

Within the scope of this work, AMEC was responsible for obtaining and compiling information with respect to the relationship between the portfolio managers and their relationship with listed companies.

ANBID - National Association of Investment Banks is the leading representative of the institutions that operate in the Brazilian capital markets, its objective being to seek the market's consolidation as an instrument for fostering the country's development.

Acting in an innovative manner, ANBID is the only class entity, which, besides representing the interests of its members, self-regulates their activities with the adoption of standards that are generally stricter than those established by the legislation. ANBID is also the principal source of information for the capital markets as well as promoting broad-based initiatives directed towards the education of investors and market professionals.

Its members are not only investment banks but also other institutions – financial (multiple banks, brokers, dealers..) and non-financial (typically the so-called independent asset managers and capital markets' consultants, incorporated as non-financial companies) – with varied profiles, having as their common denominator activities involving asset management, public offerings of securities, mergers and acquisitions, private banking, depository services and qualified services for the capital markets.

ANBID's operations are the responsibility of about 80 professionals, with roughly another 700 executives, who represent member institutions divided among the 40 different bodies of the entity. On average some 50 meetings are held to discuss topics of critical importance to ANBID's members, the market and the country every month.

ANBID's contribution to this report consisted in the systematization of information on good governance practice adopted internally by the investment funds and their relationship with their quota holders as well as information on the new standards of conduct that must be implemented by the funds as a result of ANBID's Self-Regulation Code, currently under discussion.

A not-for-profits organization founded in 1995, the **IBGC** - **Brazilian Corporate Governance Institute** is the first organ to be created in Brazil specifically focused on Corporate Governance. Among its initiatives and endeavor in this field, of special note is the preparation and revision of the Brazilian Code of Best Corporate Governance Practice.

The Institute is considered nationally and internationally as one of the principal entities responsible for the introduction of the concept of Corporate Governance in Brazil, for the recognition and dissemination of the importance of good practice and for the growing interest of Brazilian companies in consolidating their position in the market through the adoption of such practice.

IBGC today has more than 1,200 members and has been actively participating in the development of the principles of corporate governance in Brazil in partnership with the Brazilian Securities and Exchange Commission - CVM, the São Paulo Stock Exchange - Bovespa and other market entities.

IBGC was responsible for gathering the information on pension funds and the adoption of good governance practice.

1.2 Economic context

Over the past few years, the Brazilian economy has been notable in the international scenario for its vigor and strength. This can be attributed to various reasons among which key are: international market liquidity, the decline in the basic rate of interest, control of inflation and the consolidation of the capital markets.

Set against this background, the sophistication and improvement in capital markets' instruments stand out in particular, indicative of their importance for economic development and growth.

The Brazilian equity market has been developing at a fast pace. Domestic companies are alert to this fact, and are now using this medium as one of the principal sources for financing their investments.

As of July 2 2007, BOVESPA (Brazilian stock exchange)[1] had reported the listing of 30 (thirty) new companies, against 26 (twenty-six) companies for 2006 as a whole, 9 (nine) in 2005 and 7 (seven) in 2004. By value, the total volume of issues jumped from R$ 11 billion (US$ 4.7 billion) in 2005 to R$ 27 billion (US$ 12.6 billion) in 2006, by the end of June 2007 reaching the sum of R$ 25 billion[2] (US$ 12.9 billion).

The development of the capital markets has brought greater investor security following improvements in self-regulation, changes in the corporate law, adhesion of the companies to good corporate governance practice and the consolidation of institutional investors.

Investor confidence in publicly held companies has been evolving, especially in those companies whose level of corporate governance ensures greater management transparency and better information flows. At the same time, these same investors have been astonished at the ample range of opportunities for acquiring equities in companies covering broad slices of Brazilian economic activity.

In this same scenario of changes, the market has also witnessed a dispersal of shareholding control as well as hostile take-over bids, events previously only the subject of academic discussions but today a reality in Brazilian corporate operations.

Among the principal drivers behind the recent development in the capital markets, of major importance has been the amendments to Law 6,404 of 1976 and Law 6,385 of 1976, which regulate, respectively, joint stock companies, determining the rights of the shareholders, and the principles and basic rules of corporate governance. Reforms at the Brazilian Securities and Exchange Commission - CVM, the capital markets regulatory watchdog, responsible for overseeing a prosperous and secure business environment, have also been key factors, not to mention the creation of a special listing segment on the BOVESPA (Brazilian stock exchange), the *"Novo Mercado"* (New Market).

1. Information available in www.bovespa.com.br/Principal.asp
2. Information available in www.cvm.gov.br/

The two laws above were updated by Law 10,303 of 2001, which introduced material changes, those with the greatest impact involving: *(i)* the practice of buy back resulting a low percentage of shares tradable on market; *(ii)* the mandatory requirement to make a public offering prior to delisting; *(iii)* the reduction in the limit for the issue of preferred shares: *(iv)* the preemptive rights of preferred shares; *(v)* the possibility of litigation among shareholders being settled through an Arbitration Panel; *(vi)* the provision on shareholders' conflict of interests; *(vii)* the provision for shareholder responsibility for abusing voting rights; *(viii)* the self-executable nature of shareholders agreements; *(ix)* the convening of the General Meeting in specific cases, by the fiscal council and by the shareholders; *(x)* the interruption and extension of the period between the convening of the Meeting and its realization; *(xi)* the right of withdrawal in the event of a spin-off, if this implies a change in the corporate purpose *(xii)* the right of minority shareholders with 15% of the shares with voting rights or 10% of the capital stock in preferred shares to elect, in a separate vote, a member to the Board of Directors; *(xiii)* the duty of confidentiality of all stakeholders with respect to insider information; *(xiv)* the manifestation of transparency through the disclosure of market information; *(xv)* the expanded powers of the fiscal council; and (xvi) the restitution of legal tag along rights to the holders of common shares at 80% of the value paid for the control of the company.

The change in the legal environment was complemented by a far-reaching revision of the regulations issued by the Brazilian Securities and Exchange Commission. Based on some of the new legal initiatives or simply in the modernization of existing provisions, the capital markets regulator has upgraded all aspects of its procedures. Of particular note are the amendments to the rules on public offerings (CVM Instruction 361), material facts and significant holdings (CVM Instruction 358), as well as investment funds (CVM Instructions 409 and 450).

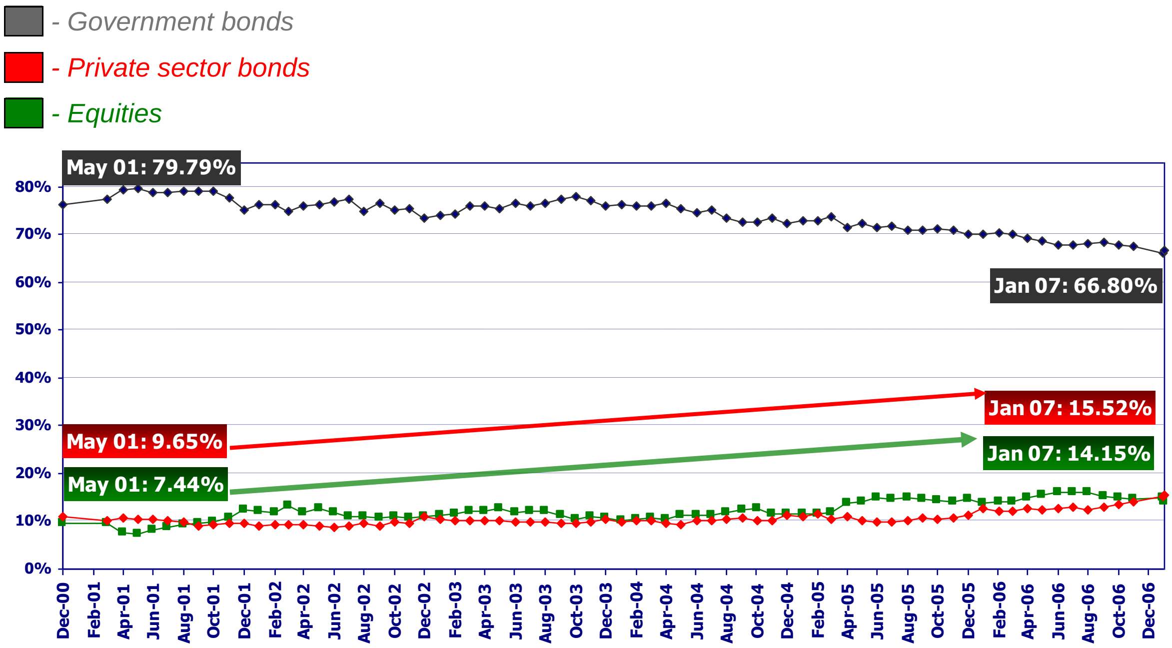
Another point in the direction of the consolidation of a robust equities market is the size that investment funds have been reaching in Brazil and consequently the activism these have been exercising. The net assets of the domestic investment funds industry have already exceeded the R$ 1 trillion[3] mark (US$ 500 billion), the 11th largest worldwide.

2. THE FUNDS INDUSTRY IN BRAZIL

2.1. Private Sector Trends in the Composition of the Portfolios

Over the past few years, the funds sector has been undergoing a significant transformation in terms of investment profile. While it is still possible to see a strong bias towards government bonds, structural changes are becoming evident. The following graph indicates the trend in these alterations: in December 2000, government bonds accounted for 79.79% of the portfolios while by December 2006, this share had fallen to 66.8%. On the other hand, the share of private sector credit – fixed income, typically represented by CDs and debentures – had risen from 9.65% to 15.52%. The most expressive advance was seen in the participation of equities, a rise of almost 100%, from 7.44% to 14.15%.

3. *Source:* Anbid, database date: June 15 2007 (www.anbid.com.br)



These figures are still only modest by world standards. Typically, in those countries that have already reached economic stability, low rates of interest and investment grade status. The investment mix has advanced to a combination of between 40% and 50% in equities and the remainder in fixed income products.

It appears that the Brazilian market is already moving in this same direction, albeit, this tendency – still limited – is not easily perceptible, since the growth in variable investments has not been so intense through equities funds, but rather through significant growth in multi-market funds, known as *“the Brazilian hedge funds”.*

These funds have seen a strong intake of new money, and are increasingly using variable income strategies. An important example of this progress was the appearance over the past few years of funds specialized in long and short strategies, This movement has triggered the creation in 2006 of a specific category for funds which focus on this investment policy. This class began with 30 funds, and assets of R$ 5 billion (US$ 2.2 billion), and now after just a year, totals R$ 8 billion (US$ 4.1 billion) and 60 funds.

2.2. Change in equity funds profile

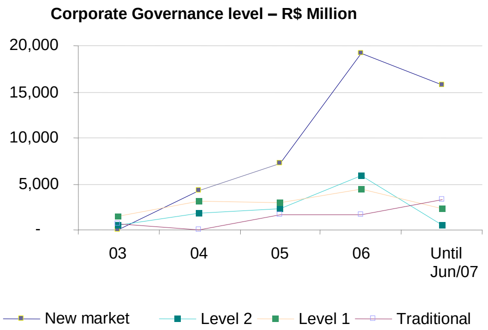
In addition to advances in the participation of variable income strategies, the equities funds’ segment has also undergone a significant change in profile. Typical funds, merely with the purpose of tracking the traditional BOVESPA index, are no longer a major attraction for the investor, and the tendency has been towards the segmentation of strategies, the highlight being the success of funds focused on dividend yield, small caps, sectors, social and corporate governance.

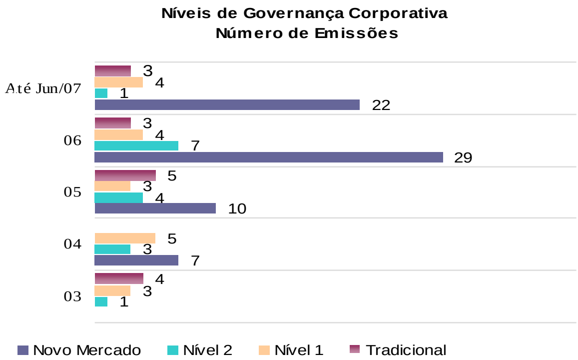
This transformation in the make-up of the portfolios (*“FIXED INCOME”*: Public Bonds → CREDIT: Private Sector bonds → *“VARIABLE INCOME”*: Equities and Multimarkets) as well as in the strategies of the equities funds (IBOVESPA → FOCUSED STRATEGY), is also a reflection of the evolution in the economic scenario of the country. For many years, the investment funds sector was an efficient generator of products either indexed to high inflation rates or to high interest rates. This *"economic function of the sector"* implied a short-term horizon, and a tendency to a low participation of equities funds.

Since the market is now moving towards a low interest rate one, it is only natural to expect a movement of: *(i)* fixed income funds investing on long term, *(ii)* an expanded participation of private sector securities and *(iii)* a change in the focus of equities funds, where passive equity portfolios are no longer enough to satisfy investor demand and requiring diversified strategies with a horizon of specific equity market and corporate values: be they in the form of dividends, strategic sector, potential company growth, social policies and added value as a reflection of corporate governance - and no longer funds that simply *"tracking market index (Ibovespa)"*.

3. GOOD GOVERNANCE PRACTICE

3.1. Current panorama





In addition to economic changes in Brazil as a whole with an impact on investor behavior, and on the funds sector profile, the equity market has already gone through an important transformation as illustrated in the graphs. The first graph shows the volume in Reais of issues since 2003 by level of corporate governance while the second shows the number of operations. In practice, share issues in the so-called traditional market without minimum governance requirements are virtually no longer an option open to companies.

3.2. Recent Past: Investment funds and Proxy voting

In an investment funds market that traditionally tracked Fixed Income benchmarks, and in an environment of stock exchange trading in which governance was not a priority, it would be only natural that a discussion of Proxy voting would not have been seen as relevant.

Even with the small percentage of equity funds that existed in the past, investments in companies on many occasions was seen as an instrument for achieving short and medium term returns. Thus, within the confines of this "investment philosophy" disagreements between minorities and controlling shareholders were merely viewed as information for pricing the security. It was therefore acceptable practice to adopt one of the known versions of the *"Wall Street Rules"- "on investments: sell a stock rather than try to change the company's policies"*, or *"selling the shares of a company whose performance is unsatisfactory".*

In the same way, the Brazilian norm always dealt with the question of political activism in vested companies as an option for the portfolio manager. It was obligatory to describe in the investment fund prospectus the *"policy relative to the exercise of voting rights of the fund by the portfolio manager or by its legally appointed representatives, in general meetings of the companies in which the fund held shares"*, there being no restrictions should the policy be specifically not to exercise voting rights – the most common stance taken over the last years.

With the maturity of the variable income market and investors taking a long term view, this investment philosophy no longer holds good, and the adoption of good governance by both funds and companies, as well as the policy of exercising voting rights have become important variable.

The market itself has perceived that these practices need to advance further and the policy of *"not exercising voting rights under any circumstances"* is no longer an option aligned with the direction in which the investment funds industry has moved: namely, a focus on the long term and with increasingly more specific strategies. Thus, the trajectories are divergent, leaving little scope for *"non proxy voting policies"*.

Beside the funds political activism question, some qualified investors began to question the independence of portfolio managers linked to large financial institutions, specially when these funds also invests in listed companies that are clients.

Answering to this concerns the large Brazilian financial institutions, inspired by foreign examples, splitting the activities of commercial banking and portfolio managing, "building" Chinese walls, implanting rough ethical codes to his partners.

3.3. The protection of minority shareholder rights in the Brazilian capital markets – investment fund activism[4]

Recent Brazilian capital markets history has brought to light several examples of cases where portfolio managers have mobilized in defense of minority shareholder rights.

Among the principal actions of the investment funds, some brief accounts of higher profile cases in the securities' market will be given through the following summaries.

TELEMAR OPERATION – The objective of the company's controllers was to promote a corporate restructuring through the incorporation of a holding company and various subsidiary companies under the umbrella of Telemar Participações S/A, the allegation being that the group's existing corporate

4. AMEC´s contribution.

structure was restricting its ability to access the capital markets and that the operation would inject greater liquidity into the company's securities.

In the light of the company's proposal, the market concluded that the exchange ratio was unduly onerous to the minorities holding the preferred shares, notably the goodwill to be paid for the controlling stake. The operation as proposed would unjustifiably dilute the participation of the preferred shareholders.

In addition to the question of the goodwill and the dilution of the minority shareholders, the Telemar operation further provoked issues involving conflict of interests, which were submitted to the regulator (the CVM) and the Law Courts.

This corporate restructuring story resonated widely in the press and resulted in an unusually high shareholder presence at the General Meeting, which rejected the proposed operation.

ARCELOR OPERATION – The operation involved the change in indirect control of Arcelor Brasil, parallel to Mittal's hostile bid for the controlling shareholder of the Brazilian steel company, Arcelor Europe.

The issue revolved around the obligation or otherwise on the part of Mittal - that acquired the indirect control of Arcelor Brasil - to hold a public offering to acquire the company's minority shareholders.

Various portfolio managers took the view that the public offering was necessary from the legislative point of view and principally on the grounds of the company's bylaws. At first Mittal rejected the idea of a public offering. However, in face of an investor outcry and a ruling from the Brazilian Securities and Exchange Commission, Mittal yielded and held a public offering for buying out the Brazilian shareholders.

However, the conditions of the public offering initially proposed were for a value below that offered to European investors. As a result, portfolio managers and minority shareholders filed a complaint with the regulator, arguing that the offer to Brazilian shareholders was unfair being less than had been offered to European investors.

The technical area of the Brazilian Securities and Exchange Commission ruled against the Mittal offer and set a price of R$ 51.27 per share, well above the approximately R$ 33,00 initially proposed, indicative that this subsequent victory was only possible thanks to direct minority shareholder pressure.

IPIRANGA CASE – This operation consists of a share purchase agreement announced in March of this year, through which the controllers of the companies of the Ipiranga Group sold their shares representing the shareholding control and the control of its subsidiaries to Ultrapar, in the role of direct purchaser and commission agent for Petrobras and Braskem.

The minority shareholders of the Ipiranga companies identified in the restructuring the possibility of an infringement of their rights and a negative impact on their assets, particularly in relation to the exchange ratio set for minority shareholders in the incorporation of the shares of the Ipiranga Group companies by Ultrapar.

Another element that caused some unease in the market related to the absence of any prior or concomitant appraisal report of the companies involved in the operation for assessing a fair exchange value.

The premature disclosure of the exchange ratio caused some turbulence in the price of the securities involved, although with the publication of the material fact the market adjusted prices using as a parameter the exchange value and the market price of the companies involved.

Even after the disclosure of the appraisal report of the companies involved in the restructuring, some questions continued unanswered following a direct analysis of the information provided in the document. In the light of this, AMEC forwarded correspondence to the chairmen of the boards of directors and the respective investor relations officers of all the publicly held companies involved as well as to the investment bank responsible for the appraisal report, requesting information and documents on the restructuring operation.

At the same time, a suggestion was put to management as to the possibility of setting up a meeting so that any clarifications deemed necessary could be provided in order to contribute to the transparency considered appropriate in the equities' market as well as for its healthy development.

TRAFO CASE – this operation involves Weg S.A.'s acquisition of Trafo and the subsequent delisting of the acquired company.

In this case, the minority shareholders were alerted to *(i)* the absence of a goodwill premium paid on the common shares of the former controller, which also had preferred shares; and, *(ii)* the inconsistencies in the appraisal report prepared by the companies for Trafo's delisting. Among these inconsistencies, particularly notable were *(a)* the zero perpetuity growth rate attributed to Trafo *(b)* the absence of any justification for the forecasted increase in raw material costs of the acquired company; and *(c)* the Brazil country risk rate used to calculate Trafo's discounted cash flow rate.

In terms of the absence of the goodwill premium, Weg paid the same price for both common and preferred shares of the former controller. However, in Brazil the tag along feature is a guaranteed right in law for holders of common shares only. Hence if the acquiring company pays the same price for the two classes of share, the minority common shareholders understand this to be tantamount to an infringement of their rights.

In addition, the acquiring shareholder proposed to delist Trafo's capital paying the preferred shareholders a lower amount than had been paid to the former controllers.

Given this scenario, the portfolio managers, represented by AMEC, requested information and documents from the board directors and investor relations officers of the companies involved in addition to those responsible for preparing the appraisal report.

NEW HYPOTHESIS FOR A MATERIAL FACT – another example of portfolio activism supported by AMEC relates to an actual case in which the minority shareholders believed their rights have been infringed, alleging insufficient transparency on the part of the vested company in the light of the latter being judicially ordered to pay a significant amount in cash relative to the net assets or company sales.

Besides the absence of any disclosure of the judicial decision, the company was also found wanting in its obligation to transparency in not disclosing to the market that it had also been required to cancel the resolution of the general shareholders' meeting, which approved the increase in capital, thereby triggering a change in the company's shareholding structure.

In Brazil, there are rules both of a legislative as well as a regulatory nature requiring a company to disclose material facts which may have an impact on the price of its shares quoted on the stock exchange, influencing the investor's decision to buy, sell or hold the securities or further, the decision to exercise any rights inherent in the condition of title owner to the securities.

Such rules serve as examples, and do not expressly require that key judicial decisions be disclosed with immediate notice to the market. Thus, with the purpose of contributing to the juridical, legislative and regulatory framework, AMEC published Resolution AMEC 02 on the need for publicly held companies to disclose information and publish as an announcement of a material fact judicial decisions or arbitration awards that contemplate material facts.

In addition to the isolated attitudes adopted in the specific cases and the regulation proposal presented, in another study, Brazilian portfolio managers are also working to get from the vested companies the adoption of good governance practices, materializing these efforts by the indication/election of board of directors members, specially members to the fiscal council.

The preference by the election of members to the fiscal council is justified by the legal rights given to the minority shareholders, who can demand the creation of the council in companies where they are not permanent, by the vote of 10% of the shares with voting rights or 5% of the capital stock in preferred shares.

Beyond the creation of the fiscal council, Brazilian corporate law has another right to the minority shareholders that allows the election, in a separate vote, of members to the fiscal council by the shareholders that owns the capital stock in preferred shares. The same right is granted to the shareholders that own at least 10% of the shares with voting rights.

The above cases illustrate that while the Brazilian equities market is showing clear signs of maturity, much remains to be done before consolidation is complete. On this point, the activism of minority shareholders, investment funds and their portfolio managers as well as firm action on the part of entities linked to good governance practice and protection of investor interests are of crucial importance to the improvement of regulatory and/or legislative rules for strengthening the capital markets. This will ensure that the investment environment can be made more transparent, more symmetrical in relation to company information and engender greater investor security.

3.4. Main issues under discussion by portfolio managers[5]

Portfolio managers have been debating various points considered of critical importance for guaranteeing minority shareholder rights as well as the conduct that must be adopted in the relationship between the portfolio managers themselves and the vested companies. Among the points are the following:

- The dissemination of mechanisms of proxy voting as a means of stimulating activism and participation of the funds at shareholder meetings of the vested companies, and with this the reduced chances of conflicts of interest arising between portfolio managers and quota holders in the exercise of voting rights;
- Raising awareness among the portfolio managers that exercising voting rights is part of their fiduciary duty to investors. There already exist CVM decisions confirming these understandings, such as CVM process 2001/1857, in which it was decided that "*For this reason, such funds normally carry the portfolio management brand in its denomination (as occurs in the case in hand): it is the name of the portfolio manager that is at stake, and, thus, its capacity of achieving success in the investments, continuing to do so in the future and progress in its activity. The entity/person that contracts this portfolio manager has no desire to manage, normally considering itself/herself/himself unsuitable for doing so or as having no vocation for such management. Indeed, this characteristic of participative investment funds would be completely distorted if quota holders could change key decisions on investments such as for example sign or no, a shareholders' agreement.*";
- Definition and disclosure of voting policies on the part of funds and portfolio managers, the vote being exercised by the portfolio managers, their in-house legal departments or lawyers hired for this purpose;
- Making a convincing case that a passive posture with respect to fund management does not comply with the fiduciary duties of the portfolio manager towards its quota holders, as well as the vested company at the meetings of which the fund manager must exercise its voting rights in the best interests of the corporation;
- The understanding that the rules of transparency, including good governance practices, are fully applicable to the portfolio managers which, in order to legitimately require the implementation of Corporate Governance in the vested companies, should adopt this same posture in relation to their investors. Based on this understanding, there should be no confusion between the principle of transparency and the disclosure of strategies, which in the

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case of portfolio managers represents the composition of the investment portfolios. The option to disclose this composition is at the discretion of the managers and explained in the fund regulations. In any case, and especially in view of the lengthening of the investment profile, the view is that the delay of 3 (three) months before disclosure is very short and that such a term should be increased;

- The lack of necessity for installing *"boards of directors"* of the funds, an entity currently absent in the configuration of Brazilian funds that adopt the juridical format of condominiums, where investors have the power of decision through their participation in quota holder meetings. At such meetings, quota holders can also pass resolutions to remove the portfolio manager. It is the belief of the portfolio managers that this legal format allows greater quota holder autonomy, thus mitigating the risks of limited independence, a characteristic of the US corporate model;
- The understanding that the implementation of investment committees pursuant to CVM Instruction 409 is seen more as a tool to be offered to exclusive funds, which in some cases carries the risk of reducing the clarity of the fiduciary duties of the manager, bearing in mind the functions of the investment committee;
- The discussion on ways to reduce absenteeism and increase the participation of quota holders in the meetings of the funds themselves. Among the possible solutions of particular importance is the earlier dispatch of more comprehensive material for examination by quota holders, detailed notices, and the transmission of quota holder meetings via webcast and the possibility of disseminating the employment of electronic voting as a useful and necessary tool for encouraging activism;
- The understanding that there is no need to audit the portfolio managers, since their products, namely the funds offered to third parties are, and should continue to be, audited. Here it is appropriate to mention that there is room for improvement in procedures for auditing funds.

3.5. Pension fund-related evaluations[6]

The Brazilian pension funds have contributed to this report by providing their analysis as to the current stage of development of the Brazilian funds industry.

Among the items in the analysis, the following are worthy of mention:

- The current scenario of declining returns from fixed income applications should increase the participation of the pension funds in the variable income and real estate markets;
- Various smaller sized funds have opted to outsource their equities' portfolios also offering differentiated profiles to their members. In parallel to this tendency, a growing activism has

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been detected combined with the interests of minority shareholders concerned with the results of inspection;

- Recent increased flexibility on the part of the National Monetary Council on the rules applicable to pension funds has permitted an increase in the limit for applications in variable income instruments through the maintenance of a reserve surplus higher than the exceeded value, thus maintaining a perfectly controlled risk profile;
- Both the inspection processes as well as the audit procedures have proved to be appropriate to the Brazilian reality, perhaps there even being rather too much detail and costs for account of the pension funds.

4. ANBID Proposal[7]

4.1 Improvements to the Self-Regulation Code for Investment Funds

ANBID, a self-regulation entity for the investment funds industry – the self-regulation, it should be noted in passing, is exercised without any powers of legal enforcement, but on the voluntary initiative of its participants - has decided to deal with the question of improvements on the basis of self-regulation. During 2007, ANBID has been progressing positively in these discussions. As from 2008, *"ANBID's Self-Regulation Code for Investment Funds"* will already be incorporating minimum practices with respect to the matter, eliminating the possibility of not exercising voting rights under any circumstances.

Despite being the subject of discussion of its members, self-regulation will also begin covering Proxy voting at General Meetings of Publicly Held Companies, but not only restricted to these assets – the policy will cover any asset class in the fund where there are voting rights, including debentures, fund quotas and other assets. Such policies should be adopted by the investment funds in the following manner:

- The rules on Proxy voting shall be compulsory to Funds which have as their investment policy the application in financial assets such as, but not limited to: *(i)* rights, share participations and stock splits; *(ii)* investment fund quotas; *(iii)* debentures, commercial papers, promissory notes, contracts, certificates and private bonds in general and *(iv)* other securities, should these assets be eligible for discussion in shareholders' meetings;
- In these cases, it is obligatory to define a *"Policy for Representation of Fund Investments in Meetings"*, covering the principles and procedures to be adopted by this representation, aligned with the *"Guidelines for a representation policy of funds in meetings"*, issued by the Anbid Funds Self-Regulation Committee;
- The regulations and prospectuses must obligatorily describe the *"Policy of Representation of the Funds in Meetings"*, either in its unabridged or simplified version, in the latter case making reference to the website where the investor can find the complete version of this policy. The

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unabridged version will also be registered at ANBID;

- The *"Guidelines for a representation policy of funds in meetings"* should be divided into four chapters: *(i)* the Purpose of the Policy; *(ii)* General Principles; *(iii)* Best Practice and *(iv)* Minimum Structure, which lists the requirements and the minimum structure for the *"Policy of Representation of the Investment Funds in Meetings"*.
- In the Chapter *"Purpose of the Policy"*, the guidelines should *(i)* describe the applicability of the policy; (ii) explain what occurs in relation to any financial asset of the fund which generates a voting right with respect to a matter of critical investor interest and *(ii)* establish that the same had already defined general parameters and which are guidelines for exercising voting rights in alignment with the investment fund policy.
- In the Chapter *"General Principles"* the policy should meet the following requisites: *(i)* that a decision to allocate a financial asset is not an *"isolated act"*, given that its possession makes the allocation decision over time a *" continuous act"*, that should provoke the process of judgment, decision and the manifestation as representative of those investors in matters which can affect their interests, and, consequently the value of the financial asset; *(ii)* that the vote is the manifestation of an opinion given in the name of the investors – in the cases in which the manager believes that such a manifestation is relevant – the decision being integral to the management of the investment fund – and as such, should be taken in a diligent manner, free of conflicts of interest, its purpose being in the best economic interests of the investors; *(iii)* that it is not obligatory to exercise voting rights in all the meetings but only in items defined by the Policy and *(iv)* that the policy should cover the decision-making standards and process that results in the decision to vote or otherwise, and, in the cases where the voting is applicable, what principles should guide this vote and how it should be formalized;
- The *"Best Practices"*, Chapter must obligatorily make clear that: *(i)* the representation is a function of the portfolio manager, since the decision is integral to the investment policy; *(ii)* establish a strategic vision of how to act in relation to aspects of governance with respect to financial assets held by the funds; *(iii)* have a broad vision of understanding of the other stakeholders on the matters on the agenda; *(iv)* maintain prior contact with the company whenever there are doubts on matters to be voted; and *(v)* monitor the execution of the decisions taken by the companies;
- Finally in the Chapter *"Minimum Structure"*, it will be obligatory to clearly define and *a priori*: *(i)* general principles guiding the voting policy; *(ii)* quantitative themes and parameters where the exercise of voting rights is obligatory; *(iii)* prior minimum periods for analyzing items on the agenda; *(iv)* a description of the decision-making process and the way in which decisions are registered and formalized; *(v)* who is responsible for the control and execution of the policy; *(vi)* procedures in the event of conflicts of interest; and *(vii)* policy for disclosing votes tendered on behalf of the investors.

The matter is at an advanced stage of discussion in the various bodies of ANBID. The current phase involves the conclusion and approval of these assumptions, subsequently passing on to the basis and juridical structure of the final text of the code, also considering the alignment of these provisions to the best IOSCO practices and to CVM rulings. This second technical phase having been concluded, the theme is to be submitted to a public hearing, this final phase entailing a discussion of the text in an open manner among all the members of ANBID, and also with the regulator.

At the end of this process, the text will be formally incorporated in ANBID's Self-Regulation Code for Investment Funds through a general meeting of members. Besides approving the text, the meeting will also decide upon the period that the new practices will come into operation. The forecast is for this process to be concluded by the end of 2007. In other words, the probability is that as from January 2008, investment funds in Brazil will be operating under policies specific to Proxy voting, thus contributing significantly to the improvement in the country's corporate governance practice.