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Brazil

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Overview

The Brazilian fund industry has shown itself to be an important element of investment strategies in the country. In 2016, the total assets under management exceeded BRL 3 trillion, distributed across approximately 14,500 funds, which represents more than half of the national GDP. Such figures place Brazil among the top investment fund industries in the world[1].

Nevertheless, several key factors have led to a risk-averse approach by investors: (i) the persistent adverse political and economic scenario in the country; (ii) the high interest rates maintained by the Central Bank of Brazil (CBB) at 14.25% *per annum* until October 2016 for the purposes of controlling the inflation rate; and (iii) the increase in the offer of income tax-free investment solutions such as real estate credit bills and agribusiness credit bills, and intensified competition between investment funds and other types of investment products.

Consequently, the investment fund industry in Brazil recorded next-to-zero net sales[2] in 2014 and 2015. Despite such scenario, Brazilian funds have mostly generated higher returns in 2015 when compared with 2014 due to the profitability of the existing investment funds, which resulted in a continuous yearly increase in the total assets under management in Brazil.

In addition, in 2016 the industry showed signs of recovery by registering net sales of BRL 109.1 billion, which represents the second-highest recorded raising of new funds, exceeded only by the one recorded in 2010 (of BRL 113.5 billion)[3].

The majority of the net sales were registered by pension funds (BRL 48.2 billion), closely followed by fixed income funds (BRL 45.9 billion).

On a yearly average, equity funds led the industry in performance, benefiting from the first yearly appreciation of the Brazilian Stock Exchange Index (Ibovespa) since 2012. High-duration fixed income funds also benefited from the interest rate decrease process started in October 2016 (currently at 13.00% *per annum*) as a result of the expected decrease in the inflation rate.

Overall, the Brazilian fund industry is, in any event, still greatly concentrated in fixed income investments, largely due to the persisting high interest rates, which has culminated in investment funds holding approximately 53% of the federal public bonds as of February 2016. With the expected decrease of the inflation rate and, consequently, the return of interest rates to lower levels, it is possible that diversification of local portfolios will intensify in the near future.

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With regard to investor segments (i.e. institutional, corporate and retail), the highest volume of investments in the Brazilian fund industry come from institutional investors, as retail investors have historically focused their investments on national saving. Furthermore, it is also possible to observe a decreasing trend of retail investor participation in the industry (24.4% in 2007 and 15.8% in 2015).

On the other hand, the participation of institutional investors and corporates in the total assets under management in the country has been steady (approximately 40% and 15% respectively) and shows an increase of allocation by such segments in investment funds.

It is also worth mentioning that the Brazilian investment fund market consists of a well-established regulatory framework enacted and enforced by the Brazilian Securities Commission (*Comissão de Valores Mobiliários – CVM*), which has in the previous years been subject to a great level of modernisation with the enactment of new rules aimed at reducing costs, as well as promoting higher disclosure of information, transparency and efficiency to market participants. In addition, the industry has benefited from a high level of product governance, provided for in self-regulation rules established by the Brazilian Financial and Capital Markets Association ("ANBIMA"). Such combined structure has been paving the way for a steady growth of the industry, irrespective of the previously mentioned adverse political and economic scenario, enabling the total assets under management in Brazil to grow from BRL 740 million in 2005 to BRL 3 trillion in 2015, with an average growth rate of 11.4% per year from 2009 to 2015.

Fund formation and finance

As mentioned above, the CVM has recently established a new regulatory framework applicable to investment funds and securities portfolio management activities. As part of the modernisation process, the CVM enacted, for example: Instruction No. 539, of November 13, 2013, which provides for suitability rules; Instruction No. 554, of December 17, 2014 ("CVM Instruction 554"), which provides for the definitions for qualified and professional investors; Instruction No. 555, of December 17, 2014 ("CVM Instruction 555"), which provides for the general rules applicable to the creation, operation, management and marketing of investment funds; and Instruction No.º558, of March 26, 2015 ("CVM Instruction 558"), which provides for the rules applicable to the accreditation, ongoing obligations and rules of conduct for securities portfolio managers, as further detailed below.

<u>Portfolio management</u>

The local professional management and administration of securities portfolios can only be carried out in Brazil by a natural person or a legal entity duly authorised by the CVM. It is important to highlight that such natural person must be resident in Brazil, and the legal entity must be organised and headquartered in Brazil.

CVM Instruction 558, effective as of January 4, 2016, introduced important amendments to the securities portfolios management activities in light of the industry development.

A first significant innovation is the regulatory recognition of a practical distinction already developed by the industry; that is, the two categories of portfolio managers with different areas of expertise: (i) fiduciary administrators, with direct or indirect responsibility for the custody and control of assets and liabilities and, generally, for the supervision of the markets; and (ii) asset managers, with responsibility for the decision-making process on investments.

As a result, portfolio managers, depending on the activities they perform, shall request their

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registration under the fiduciary administrator category, under the asset manager category, or under both.

Further, CVM Instruction 558 introduced the need to assign certain responsibilities to statutory officers (e.g. compliance and risk management) in addition to the asset management responsibilities. It also improves the rules of conduct, information duties and segregation rules with the purposes of promoting a higher level of governance and structure by portfolio managers.

As part of the CVM's efforts to promote a higher level of transparency for investors, CVM Instruction 558 also introduced the requirement for portfolio managers to prepare and keep updated a reference form similar to a prospectus applicable to listed companies. It is important to note that such reference form must be annually filed with the CVM as well as posted on the portolio manager's website. Portfolio managers must also publish their internal policies and manuals on their website.

Another significant change brought by the new rule is the possibility of portfolio managers to distribute quotas of managed funds, an activity generally the province of duly qualified entities pertaining to the Brazilian securities dealership system (e.g. financial institutions).

The new provision seeks to eliminate a significant obstacle to the access of new portfolio managers to the market, which now are authorised, even if not accredited as securities distributors, to distribute quotas of managed funds (i.e., they are not authorised to distribute quotas of third-party funds). Nevertheless, portfolio managers who intend to distribute quotas of managed funds must follow specific CVM rules applicable to securities distributors.

The rendering of securities advisory services is also subject to the prior authorisation of the CVM, however, pursuant to CVM Instruction 558, asset managers accredited with the CVM will be automatically authorised to provide securities advisory services. This means that duly accredited asset managers will no longer need to obtain a separate accreditation to provide investment advisory services.

Most recently, the CVM has also set for public hearing a proposed rule to replace and regulate in detail investment advisory activities, in order to include similar requirements for accreditation and ongoing obligations as the ones provided for in CVM Instruction 558.

<u>Investment funds</u>

As mentioned above, the creation, management and operation of most investment funds in Brazil are currently regulated by CVM Instruction 555, effective as of October 1, 2015. Nevertheless, it is worth mentioning that certain types of funds are subject to specific CVM regulations, including, for example, receivables investment funds (FIDCs); real estate investment funds (FIIs); and private equity funds (FIPs).

Under Brazilian law, investment funds are characterised as a pool of funds incorporated under the form of a condominium (i.e. they are not legal entities) intended for investments in assets traded in the financial and capital markets, pursuant to the terms and conditions set forth in their bylaws.

A condominium is a type of unincorporated entity in which two or more persons hold joint title to certain assets, being attributed a notional part (quota).

Even though they do not have a legal personality apart from that of their quotaholders, orders for the purchase and sale of securities are carried out in the fund's name.

Investment funds can be divided into closed-ended and open-ended funds. Generally, open-ended funds are characterised by the possibility of quotaholders to redeem their quotas at

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any time, and a prohibition, as a general rule, on quotas being assigned or transferred.

Closed-ended investment funds, on the other hand, do not allow the redemption of quotas at any time, except in case of liquidation of the fund; and their quotas may be transferred, by means of a term of assignment and transference, or through a stock exchange or over-the-counter (OTC) market.

Pursuant to CVM Instruction 555, investment funds are incorporated and legally represented by fiduciary administrators, who are, *inter alia*, responsible for registering the fund with the CVM, controlling the fund's assets, and their compliance with the regulations and the fund's bylaws, as well as communicating with investors and the CVM. The investment decisions of the fund are subject to the discretionary management of asset managers, pursuant to the investment policy outlined in the fund's bylaws.

The fiduciary administrator may also hire other service providers on behalf of the funds, more commonly represented by custodians and distributors.

The CVM also simplified the existing types of funds, which are now represented by just four classes (with possible subclasses) as opposed to the seven classes provided for in the previous regulation. The new classes of funds are: (i) fixed income, focusing on the variation of interest rate and/or price indices; (ii) equity, focusing on the price variation of equity securities traded in the organised market; (iii) foreign exchange, focusing on the price variation of foreign currencies and/or exchange coupons; and (iv) multimarket, with multiple investment strategies in different markets.

Among the changes introduced by CVM Instruction 555 to the Brazilian investment fund industry, are also worth mentioning: (i) the possibility of all communication with quotaholders being carried out electronically; (ii) higher threshold and flexibility for offshore investments by investment funds pursuant to the target investor; (iii) new rules regarding performance and rebate fees; and (iv) a new set of mandatory fund documents seeking higher transparency and celerity.

CVM Instruction 555 establishes that investment funds are, as a general rule, prohibited from taking and/or providing loans. Investment funds may, however, use their assets to provide collateral on proprietary transactions, as well as borrow and lend financial assets provided that the loan transactions are carried out exclusively by means of authorised services by the CBB or the CVM.

<u>Investor classification</u>

CVM instruction 554, which came into effect on October 1, 2015, jointly with CVM Instruction 555, better defined the investor type classification. The rule now differentiates three types of investor categories: (i) retail; (ii) qualified; and (iii) professional.

Apart from specific entities that are directly classified either as professional or qualified investors, the rule generally defines that professional investors are individuals or entities with total financial investments in excess of BRL 10 million, and that qualified investors are individuals or entities with minimum financial investments in excess of BRL 1 million. Retail investors are, therefore, those that do not fall under the previous categories (by exclusion).

<u>International investments</u>

It is possible to say that the aforementioned regulations also have the purpose of facilitating Brazilian investors to access foreign investments.

From a general perspective, CVM Instruction 555 raised the limits for investment funds to invest offshore when compared to the previous regulation.

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In that respect, it is worth mentioning that retail investment funds may now invest up to 20% of their total assets under management in foreign products. In addition, with the new investor classification, there are clearer and simpler rules for investment funds aimed at professional or qualified investors to invest all of their assets under management abroad. Another innovation is that there is no longer a minimum investment required in order to acquire quotas of such foreign investment funds, but rather that investors be professional or qualified investors as the case may be.

Similarly, the CVM and the CBB have also enacted new rules with the purpose of facilitating foreign investments in the Brazilian capital and financial markets. An example is the possibility of depositary receipts to have debt securities (also known as global depository notes – GDNs) as underlying securities. Previously, only equity securities (shares or other securities that represent equity rights issued by publicly held companies in Brazil) were authorised to be traded abroad via depositary receipts.

This means that Brazilian publicly held companies and financial institutions may now issue depositary receipts in foreign markets that represent, among others, debentures, notes, certificates of real estate receivables, all of them issued in Brazil.

Foreign investments in the Brazilian capital and financial markets must be duly registered with the CBB and the CVM, as well as meet other additional requirements provided for in the applicable regulations. As a general rule, such investments must be made in organised capital markets (e.g., stock exchanges and OTC markets).

In addition to investing in the Brazilian capital and financial markets, foreign investments can also be made directly in the form of equity of Brazilian companies. Such investments shall also be registered with the CBB, under the Electronic Registration System – Foreign Direct Investment.

Foreign exchange

Brazil still has very strict controls on foreign exchange transactions (i.e., on the inflow and outflow of funds to and from the country). Pursuant to the Brazilian foreign exchange regulations, all exchange transactions must be carried out through an authorised exchange entity in Brazil.

In addition, a relevant foreign exchange contract containing, *inter alia*, the parties, date, nature of the transaction and exchange rate, must be signed. All foreign exchange transactions must also be registered at the CBB electronic data system (SISBACEN).

Offering of foreign securities in Brazil

Under Brazilian law, the offering of foreign securities is subject to regulation that affects the possibility of offering such products on a public basis in Brazil.

The public offering of securities in Brazil is primarily regulated by the Brazilian Securities Market Law and CVM Instruction No. 400, of 29 December 2003, as amended, which, as a general rule, establishes that public offerings must be previously registered with and authorised by the CVM.

Foreign securities are generally not eligible for registration in Brazil. Therefore, in order for foreign entities to offer their products in Brazil, they shall adopt certain procedures to avoid their public disclosure in Brazil.

It is also important to stress that there is no definition under Brazilian law of what constitutes a private placement of securities. Consequently, the concept of private placement is based on what would not constitute a public offering under Brazilian law and, therefore, would not require registration with the CVM.

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Individuals or legal entities resident in Brazil are permitted to invest abroad, provided that information relating to such assets owned abroad is fully disclosed to the CBB and the Brazilian tax authorities. The obligation to disclose to the Brazilian authorities the existence of assets owned abroad lies exclusively with the owners of such assets.

Nevertheless, specific entities of the Brazilian financial system, such as pension plans, insurance and reinsurance companies, governmental entities, banking companies and investment funds, have certain limitations when it comes to investing abroad (e.g., rules regarding portfolio diversification and asset concentration limits per investor and type of asset).

Key developments

As detailed above, the regulations dealing with the fund industry in Brazil have been significantly amended recently, with further amendments expected for ancillary rules. It is important to note that such changes have been largely influenced by the evolution of market practice and demands made by market participants, with proposed rules being set for public hearing by the CVM and subject to receiving comments from the public.

After 10 years of the enactment of the previous regulatory framework, the new regulations have been designed to bring more efficiency, transparency and competitiveness to the fund industry. They also mark a maturity of the local market, requiring improved structures, governance, transparency and professionalism from market participants.

The new regulations further demonstrate that the regulator has been mindful of the industry's dynamic, facilitating investment opportunities demanded by the market with more flexibility and simplicity.

An example is the creation of the simple funds, which is a subclass of fixed income funds, targeted to retail investors for basically allocating investments in federal public bonds as an alternative to savings accounts.

Further, as mentioned above, investment in foreign markets has become more accessible to Brazilian investors, and an increase of investment funds aimed at investing offshore should be noted.

Local funds operate mainly by investing in local assets for local clients, with local funds investing in foreign products representing currently only 0.5% of the total.

Conversely, the allocation of global investors, through funds located abroad, in local assets is already developed, albeit adversely impacted by the current political and economic scenario in Brazil. Pursuant to the CBB's data, in March 2016 the total amount of global portfolios allocated in Brazilian sovereign bonds was USD 235 billion, and USD 176 billion in equities (including funds and direct portfolios' allocation).

Further, Brazilian regulatory authorities have been demonstrating a stricter stance on compliance. Since the strengthening of the anti-money laundering regulations in 2012 with the enactment of Law 12,683, of July 9, 2012, important anti-corruption rules have also been enacted (Law 12,846, of August 1, 2013, and Decree No. 8,420, of March 18, 2015).

The year ahead

The Brazilian industry has demonstrated its resilience in the face of the adverse external factors mentioned previously. Part of such resilience derives from its well-established structure and improving regulations, which have worked to sustain growth in the industry and should pave the way for the recovery and resurgence of the industry once the political and economic factors show signs of stabilisation.

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It is also worth mentioning that the new regulatory framework is still very recent, with market participants, and the CVM itself, still in the process of better understanding and testing the new regulations.

In that respect, it is important to stress that by increasing monitoring and disclosure duties of portfolio managers, CVM Instruction 558 tends to, directly or indirectly, generate additional costs to market participants. The CVM's intention was to promote the existence of better-structured portfolio managers (irrespective of their size), as well as facilitating the analysis and comparison between portfolio managers by investors.

Externally, a decreasing trend of interest rates is observed as the inflation rate approaches the target median rate of 4.50% *per annum*, and the expansion of domestic economic activity still struggles. In this regard, the CBB recently lowered interest rates by 0.75% (from 13.75% to 13% *per annum*). This should incentivise investor appetite for riskier and diversified products, including in the investment fund industry, which is still still very focused on fixed income.

Institutional investors and corporate segments should continue outsourcing asset management through funds due to the benefits related to transparency, governance and operating gains, the latter explained by asset managers reducing internal management work, and administrators easing investment accountability by providing daily net asset value.

For individuals, the competition between investment funds and other type of investment opportunities will continue to increase, which may lead to a consistently healthy market environment, provided that all investment opportunities are sold under the same criteria, including the investors' suitability analysis.

In this sense, the simplification of fund investment rules could assist in the growth of the industry with the intensification of retail investor participation. This is exemplified by the creation of the simple funds, the distribution through digital platforms and the offer though open platforms.

In addition, CVM Instruction 555 offers new and efficient investment opportunities for local and foreign investors, especially with regard to the accessibility of foreign markets by Brazilian investment funds. This should generate greater interest for the development of new feeder funds designed for allocating local clients' investments abroad.

The growing trend of accessing global products can also benefit the ever-increasing pension fund segment. Nevertheless, it still faces regulatory barriers that limit pension funds to invest only up to 10% of their total assets under management abroad, and only through local investment funds. In addition, each pension fund may not hold more than 25% of the total assets under management of an investment fund.

The evolution of the sales of global products in Brazil also depends on another external factor – currency stability – given that local investors are still averse to assuming a currency risk that may exceed the return on investment made abroad.

In conclusion, it was seen that the investment fund industry presented rapid growth in the last decade, with a recent period of stagnation. Nevertheless, the latest numbers show that the growth rate is expected to increase once more, and could intensify if macroeconomic adjustments are made to boost the Brazilian economy.

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Endnotes

1. Based on information provided by the 2016 *Brazilian Mutual Fund Industry Yearbook* published by the Center for Studies in Finances of Fundação Getúlio Vargas.
2. Meaning the difference between the amounts related to new investments versus redemptions.
3. Based on information provided by the ANBIMA Investment Funds Report No. 129 of January 2017.

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