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Brazilian Capital Market: Conversions, Privatization, and Venture Capital Investment

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ARTICLES

BRAZILIAN CAPITAL MARKET: CONVERSIONS, PRIVATIZATION, AND VENTURE CAPITAL INVESTMENT

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I. INTRODUCTION

During the last twenty-five years the Brazilian capital market[1] has exhibited dynamic growth and development. In part, this growth is due to the industrialization of the economy and the need for increased capital funds. Increased income, higher savings, and more effective mobilization of domestic funds have also played a major role in this development. The efforts on the part of the government to promote the development of the capital market have been equally important.

Three distinct trends have occurred in Brazil which represent qualitative aspects of the capital market development and improvement. These trends include: 1) the formation of an appropriate legal structure, 2) the development of financial intermediaries that operate primarily in the capital market, and, more recently, 3) the emergence of a venture capital industry.

In order to analyze these trends, Part II will focus on the general financial system reform that has taken place over the past three years. Part III will describe briefly the normalization of the capital market through the legislation enacted in 1964 to 1965 and again in 1976. This legislation establishes a basic legal structure that protects investors, mandates adequate levels of corporate disclosure, and establishes rules of conduct in the open market. Part IV will then address the introduction and evolution of various financial intermediaries that operate in the capital market, including the pension funds and mutual funds. Parts V and VI will analyze the debt conversion and privatization programs introduced formally in 1988, since one may consider these programs necessary ingredients in the development of a venture capital industry in Brazil. Part VII will describe the emergence of a venture capital industry. More important, this section will examine the appearance of special risk-taking funds that carry out venture capital activities.

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1. Generally, capital markets are markets for long-term investment funds.

II. Financial System Reform

If one were to attempt to characterize the Brazilian financial market sector in the late 1980s, the best possible term might be "change." Policymakers in many departments of the Brazilian government appear to be uniform in their resolve to plan and initiate reform of the financial system. This article will focus primarily on two categories of reform, namely, external debt conversions and privatization[2] and will discuss the emergence of a venture capital industry in Brazil.

In 1987 to 1988, there were strong incentives for reforms in external debt conversions and privatization because of the internal economic environment, external debt crisis, and basic economic necessity.[3] During this period, failure of the Cruzado Plan[4] and the accompanying escalation of inflationary pressures interrupted the strategy of the government to achieve budgetary balance. Although inflation was held to twenty-two percent in 1986, it accelerated to 365 percent in 1987 and to 904 percent in 1988.[5] The government no longer could finance industrial investment due to its budgetary position and the closing down of external sources of capital. Moreover, the general economic environment in Brazil had become less certain, reinforcing a weakness in investment expenditures of domestic and foreign enterprises. In February 1987, the government imposed a moratorium on payment of interest on debt held by international banks, which extended until June 1988 when a new debt rescheduling agreement was reached with the coordinating committee of bank creditors to deal with the external problem.[6] Nevertheless, the conclusion of this debt agreement would not satisfy the basic economic need of the Brazilian economy, namely, channelling liquid funds into active investment programs to activate the economy more.

Despite these measures, between 1987 and 1988 Brazil moved into a recessionary phase of its business cycle. In the first quarter of 1988, industrial production was nine percent lower than a year

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2. Other areas of proposed reform include the proposal for all service banks (bancos multiplos), budget reforms in the federal government, and a change in the conduct of open market operations in government securities which are carried out by the Central Bank.

3. Int'l Bank for Reconstruction & Dev., World Bank, World Development Report 1988, at 34-35 (1988).

4. *See O Novo Cruzado*, 41 Conjuntura Economica 25 (1987).

5. Central Bank of Brazil, 19 Brazil Economic Program 25 (1988).

6. *Debt Rescheduling Accord Ready*, Gazeta Mercantil, June 27, 1983, at 3.

earlier,[7] and there were indications that only moderate improvement in this sector for the balance of the year was likely. In July 1988, the National Bank for Economic and Social Development ("BNDES") reported that Brazil's trade balance in capital goods had deteriorated during the 1980s, reflecting a loss of competitiveness compared with other countries.[8] The BNDES report suggested that Brazil needed to better integrate advances in technology into its production processes.[9] The report concluded that Brazil needed to develop an industrial strategy oriented toward global cooperation between Brazilian and foreign research and development enterprises.[10]

To summarize the situation, in 1988 it had become clear that the Brazilian economy needed to find a way to restore high levels of investment expenditure. Unfortunately, there were few alternatives, given the budgetary position of the government, the general economic environment, and the external debt situation. As a result, Brazil used two programs as partial solutions to these problems. One program, the debt conversion program, aimed to gradually reduce the external debt, but more important, a liquidation of these claims so that new investment could be carried out.[11] The other program, a privatization program, aimed to improve the efficiency of the industrial sector, by transferring portions of the industrial sector controlled by the government to private control and operation.[12] As the discussion in Part III will indicate, both of these programs provide significant opportunities for development and innovation in the capital market. In addition, they offer a wider and more diversified base of capital market transactions needed to feed an emerging venture capital sector.

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7. *Industrial Production Statistics*, 42 CONJUNTURA ECONOMICA 58 (1988).

8. Costa da Sucursal, *BNDES Quer Conter a Defasagem Tecnologia*, Correio Brasiliense, July 11, 1988, at 5.

9. *Id.*

10. *Id.*

11. Monteiro, *Conversão de Creditos em Investimentos—O Caso Brasileiro*, 42 CONJUNTURA ECONOMICA 91-93 (1988).

12. Moreira, *O Grande Desafio*, in PRIVATIZAÇÃO, MERCADO DE CAPITAIS E DEMOCRACIA 323 (1988).

III. Capital Market Development

A. *Current Situation*

Brazil has developed a complex and sophisticated capital market sector. There are nine stock exchanges, the two largest in Rio de Janeiro and São Paulo.[13] In 1987, these two exchanges accounted for ninety-seven percent of the value of all transactions on the nine exchanges.[14] In that year the aggregate value of all transactions on the nine exchanges was US$7.3 billion,[15] with approximately 650 companies having their shares registered for trading.[16]

The development of the stock exchanges has been furthered substantially by government policy. The stock exchanges offer Brazilian companies the opportunity to obtain new capital by offering shares in the primary market. In 1986, a record US$1.2 billion of such financing took place.[17] Similarly, new debenture issues could be placed in the primary market, although the volume of new financing using this means is considerably smaller than in the case of new share issues.[18]

Financial institutions have played a critical role in the development of a capital market. These institutions add to the liquidity of the capital market and channel new funds into it. A variety of capital market institutions now operate, investing in shares, debentures, federal government securities, state and local government securities, mortgage instruments, and other financial assets.[19] At the end of 1986, six major types of institutions had combined asset portfolios of Cz$155.9 billion.[20] Since 1986 there has been strong growth in mutual funds created to invest primarily in short-term instruments.[21]

In 1988, sixty-four of these funds were operating with re-

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13. Comissão Nacional de Bolsas de Valores, Relatorio 1987, at 31 (1988).
14. *Id.*
15. This figure is arrived at by using the average cruzado-dollar exchange rate in 1987. Basically there are four types of trading on the nine stock exchanges: sight, term, options, and exercise of options.
16. Comissão Nacional de Bolsas de Valores, Relatorio 1985, at 25 (1986).
17. Rio De Janeiro Stock Exchange, Fact Book 1988, at 35 (1988).
18. *See* Moreira, *supra* note 12, at 323.
19. Banco Central do Brasil, Relatorio 1986, at 47-54 (1987).
20. *Id.* at 54.
21. Jornal de Brasilia, July 9, 1988, at 6; Galazi, *As Muitas Opções de Lucros*, 1988 Bolsa 9.

sources of Cz$977 billion (US$6.1 billion).[22] The total capital of share, fixed income, and short-term funds at February 1988 was US$8.2 billion.[23] Given the substantial increase in value of shares on the Brazilian stock markets in the first half of 1988, these figures understate the role of the share funds in the capital market.[24]

B. *Development of the Legal Structure*

Over the past twenty-five years in conjunction with its capital market sector, Brazil has developed a sophisticated and complex legal structure, aimed at promoting the growth of its financial markets. Since the mid-1960s, Brazil has made a great deal of progress in the development of its capital market. In part, this progress has been accomplished by building a sound legal base. Until the mid-1960s, Brazil lacked modern securities markets and well developed financial intermediaries. The first important government measures, addressing these problems, came during 1964 to 1965. At this time, two important laws were enacted, namely Law No. 4595,[25] which created the National Monetary Council ("CMN") and provided a stable framework for the operation of banking and financial market institutions, and Law No. 4728,[26] also known as the Capital Market Law, which provided for the creation and the regulation of new institutions and financial market incentives.

As provided for in Law No. 4595, the CMN sits at the top of the financial structure coordinating the activities of the Central Bank and National Securities Commission. The Central Bank, in turn, implements decisions of the CMN and supervises financial institutions.[27] Until 1976, when the National Securities Commission was created, the Central Bank was responsible for administering the provisions of Law No. 4728.[28]

Law No. 4728 was the first comprehensive set of rules for the development of the capital market in Brazil. It empowered the

22. Jornal de Brasilia, *supra* note 21.

23. *See infra* app., table 2.

24. *Ações Ganho Real de 110% no Semestre*, O Globo, July 11, 1988, at 16.

25. Law No. 4595 of December 31, 1964, *reprinted in* COMISSÃO NACIONAL DE BOLSAS DE VALORES, LEGISLAÇÃO SOBRE MERCADO DE CAPITAIS 1-28 (1986) [hereinafter LEGISLAÇÃO].

26. Law No. 4728 of July 14, 1965, *reprinted in* LEGISLAÇÃO, *supra* note 25, at 29-62.

27. *See supra* note 25.

28. Law No. 6385 of December 7, 1976, *reprinted in* LEGISLAÇÃO, *supra* note 25, at 80-93.

Central Bank to establish and supervise the stock exchanges, register new issues of securities, and supervise financial disclosures by companies.[29] This law provided that the CMN could establish minimum capital requirements for brokerage companies and rules for operation of the stock exchanges, including brokerage commissions and margin requirements.[30]

Law No. 4728 also established guidelines for access to the financial markets and required that registration with the Central Bank precede an issue of new securities.[31] Further, this legislation provided more flexible use of bond and debenture issues, including use of monetary correction to keep up with inflation.[32] This law sought to establish an institutional market for securities and gave the Central Bank authority to approve the creation of investment funds.[33] Tax incentives were provided for investors holding shares in open capital companies.[34]

The Capital Market Law provided an important stimulus to the development of the Brazilian financial markets. It organized and consolidated the law governing the capital market into a more orderly system. Equally important, it brought new institutions into the capital market. Prominent among these institutions were the investment banks which were authorized to carry on direct lending, purchase of shares, and issue of guarantees. Probably the most important contribution of Law No. 4728 was its requirement of information disclosure by companies whose securities are traded on the stock exchanges.[35]

Firms were required to submit financial statements and securities to the Central Bank, which could refuse registration if it decided the financial data was incomplete or inadequate.[36] In short, through the passage of this law the government established and defined the basic institutional structure for financial development.

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29. *See supra* note 26.
30. *See id.* arts. 7-10.
31. *Id.* arts. 17-21.
32. Law No. 4728 permitted issue of debentures with monetary correction. *See id.* arts. 26 & 27. An issue of this kind would protect the investor from the erosion of value due to inflation, and make securities more attractive to investors. Since 1965, virtually all debentures issued in Brazil have become protected by monetary correction.
33. *Id.* arts. 49 & 50.
34. Open capital companies are companies which register their shares with the stock exchange and make their shares available to public ownership and trading.
35. *See supra* note 26, arts. 20 & 21.
36. *Id.* arts. 16 & 17.

In 1967, the government adopted a fiscal incentive measure to promote financial institution development, namely, Decree Law No. 157.[37] The approach taken in this legislation could be termed a "forced savings" approach, designed to channel funds into the stock market. This law required taxpayers to use part of their income tax liabilities to purchase shares of Fiscal Funds. In effect, the use of these funds was a new approach that went beyond marginal incentives to encourage wider ownership and more active trading of shares.[38] Investment banks, finance companies, and brokerage firms managed the Fiscal Fund portfolios, creating a large pool of savings. A strong stock market boom followed, which ended in 1971 with major reversal and decline.

C. *The Second Round of Legal Reforms*

In 1976, Brazil implemented a second round of legal measures, because by the mid-1970s it became clear that if the capital markets were to grow at a pace consistent with the needs of the economy, several problems required immediate attention. The need to restore investor confidence and credibility in the stock market system, the absence of a government agency given the specific task of supervising the securities markets, the need for more detailed disclosure and financial reporting by companies, and limited development of institutional investors in the capital market, were four of these pressing problems. In response to these problems, two laws were passed in 1976, Law No. 6385, which created the National Securities Commission ("CVM"), and Law No. 6404,[39] which established an improved system of corporate disclosure and shareholder protection.

Law No. 6385 is a cornerstone of the capital market. It created a system of surveillance over capital market activities and institutions. Major provisions of this law include:

1) creating the CVM, its areas of jurisdiction, and the scope of

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37. Legislative Decree No. 157 of February 10, 1967; *see also* L. TRUBEK, LAW, PLANNING AND THE DEVELOPMENT OF THE BRAZILIAN CAPITAL MARKET 56-58 (N.Y.U. Inst. Fin. Bull. Nos. 72 & 73, April 1971).

38. R. Teixeira da Costa, The Brazilian Experience in the Development of a Capital Market 12 (May 1987) (paper presented at International Investment Conference, Istanbul, Turkey).

39. Law No. 6404 of December 7, 1976, *reprinted in* LEGISLAÇÃO, *supra* note 25, at 94-201.

its broad powers;[40]

2) extending authority to the CVM to register securities prior to their distribution and trading;[41]

3) granting the CVM authority to issue regulations concerning publicly held companies and the disclosure of transactions in company shares;[42]

4) extending jurisdiction to the CVM over the administration of portfolios and custody of securities;[43] and

5) granting the CVM authority to register chartered accounting firms and independent accountants.[44]

The second important piece of legislation was Law No. 6404 also known as the Corporation Law.[45] This law protects the stock market through its institutional framework.[46] Also, it provides the corporate manager with the legal and financial requirements for modernization of Brazilian companies.[47] Most important, Law No. 6404 set up a regulatory system designed to give investors confidence in the capital market.[48] Among other subjects, this law gives close attention to the following areas: corporate disclosure and presentation of financial statements, shareholder protection, issuance of shares and debentures, and corporate governance.[49]

IV. Expanded Legal Framework for Financial Intermediaries

Beginning in 1977, several laws and resolutions were promulgated which were aimed at encouraging the development of financial institutions in the capital market. In 1977, Law No. 6435 was enacted, which provided detailed rules for the creation and operation of private pension funds.[50] Since 1977, these institutions have

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40. *Supra* note 28, arts. 3-14.
41. *Id.* arts. 15-17, 19-20.
42. *Id.* arts. 21 & 22.
43. *Id.* art. 23.
44. *Id.* art. 26.
45. *See supra* note 39.
46. *Id.* chs. 1 & 2.
47. *Id.* ch. 1, arts. 1-3.
48. *Id.* chs. 4 (beneficial interests of stockholders), 7 (organization and administration of companies and issue of shares) & 9 (regulation of changes in capital of a publicly owned company).
49. *Id.* chs. 3-5 (issue of shares and debentures) & 9 (disclosure and presentation of financial statements). *See also id.* chs. 9, 10, 14, 16 (shareholder protection), 11, 20 & 21 (corporate governance).
50. Law No. 6435 ushered in a new era in Brazilian capital market development. In the

experienced rapid growth, such that by 1980, their resources were twice as large as resources of insurance companies.[51] Basically, there are two types of pension funds: closed funds, which are managed by sponsoring firms and provide benefits to covered employees; and open funds, which are managed by banks, securities companies, and special investment management firms. The resources of closed pension funds are considerably greater than resources of open funds.[52] Still, pension funds have become the largest institutional investor group in the capital market.[53] However, mutual funds have also displayed high growth, especially since passage of Resolution 1199[54] which authorizes the creation of mutual funds for investment in short-term assets.[55]

Central Bank Resolution 1184 allows the creation of venture capital companies. Generally, venture capital firms invest their resources in smaller Brazilian companies, whose securities are not listed for trading on stock exchanges. This resolution bestows financial incentives on companies that receive investments from venture capital companies.[56] Among the incentives is the right to exclude from taxable income the dividends and profits paid to venture capital investors.[57]

One can find authority to create Patrimonio Individual to Trabalhador ("PAIT") Funds in Decree Law No. 2292.[58] PAIT Funds serve as a tax deductible savings plan for workers, and can be established by individuals as well as companies. The tax incentive for these plans remains available provided that invested funds

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ten year period between 1977 and 1987 pension funds grew to become the largest single capital investor. *See infra* app., table 1.

51. *See* Banco Central do Brasil, Res. 1184, 124 D.O. 13399 (Sept. 5, 1986).

52. *See infra* app., table 1.

53. COMISSÃO DE VALORES MOBILIARIOS, RELATORIO 1986, at 32-37 (1987).

54. Resolution 1199 of October 10, 1986. *See also* BANCO CENTRAL DO BRASIL, RELATORIO 1986, at 120 (1987).

55. *See* Resolution 1199 of October 10, 1986. For data indicating the size of these funds, see *infra* app., table 2.

56. The financial incentives available to venture capital companies under Brazilian regulations include: 1) tax deductibility of dividends received by the venture capital company for the dividend paying company; 2) tax exemption for the venture capital company of dividends received and capital gains originated from investment or liquidation of participation; and 3) taxation of stockholders of venture capital companies at a rate of 23% on proceeds received and capital gains originated in the sale of the participating company.

57. R. Teixeira da Costa, The Venture Capital Industry in Brazil (June 1988) (paper presented at the Investing in Brazil Conference, São Paulo, Brazil).

58. *See* Law No. 2292 of November 21, 1986 and implementation measures contained in Decree 93,989 of Jan. 30, 1987.

are not withdrawn before ten years.[59] These funds are administered by investment banks and securities firms. Their investments are regulated in a manner similar to that applicable to share mutual funds.

Foreign capital investment funds are regulated by Resolution 1289[60] and are subject to supervision of the Central Bank and the National Securities Commission.[61] Although under Resolution 1289 three different types of legal entities can be established, their operational purpose, to obtain capital from foreign investors and invest the majority of funds (minimum seventy percent) in listed shares,[62] is similar.[63] As of mid-1988 these funds had not attracted substantial foreign investment funds.[64]

V. Debt Conversion Program

A. *The Debt Problem—Major Issues*

Since the onset of the external debt crisis in 1982, many solutions have been offered, yet few have been implemented. During 1982 to 1986, an optimistic interpretation persisted concerning Brazil's large external debt, namely, that Brazil faced a liquidity crisis more than a problem of basic insolvency.[65] This attitude changed in 1986 to 1987 as the Cruzado Plan proved a failure, and as inflation persisted and even escalated. The February 1987 moratorium declared by Brazil on external debt service ushered in a new pessimism, amplified by debt write-offs by large creditor banks.[66]

In this same period, international banks traded Brazilian debt paper in a secondary market at discounts of twenty to thirty per-

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59. *Id.*

60. Resolution 1289 of March 20, 1987. *See generally* BANCO CENTRAL DO BRASIL, RELATORIO 1987 (1988).

61. Resolution 1289 of March 20, 1987.

62. *Id.*

63. *Id.*

64. *See, e.g.*, FIRST BOSTON CORP. & MERRILL LYNCH CAPITAL MARKETS CORP., THE BRAZIL FUND PROSPECTUS 34 (March 31, 1988) [hereinafter BRAZIL FUND].

65. This view prevailed despite the need for Brazil to rigidly force its balance of trade into surpluses. These surpluses exceeded US$12 billion a year to generate the amount of foreign exchange needed for interest payments on nearly US$70 billion of external debt owed to banks and US$40 billion of official debt owed to governments and international organizations. *See* Burnhill, *Commercial Banks and the Moratorium*, 8 INFOBRAZIL 10 (1987).

66. *Id.*

cent of the face value.[67] In 1987, this market suffered a sharp decline because of creditor banks announcements of a moratorium and write-off of Brazilian loan paper.[68] By the middle of 1988, Brazilian debt paper had recovered to a little over fifty percent of its original face value,[69] reflecting the conclusion of a negotiated debt rescheduling with the creditor banks, and the resumption of payments of interest on external debt owed to international banks.[70]

In response to the debt problem, debt conversion has been regarded as a partial but necessary solution.[71] Until the formal debt conversion problem began in 1988, only limited amounts of Brazilian debt had been converted.[72]

Generally, external debt can be converted into risk capital (equity shares) or other debt. In this conversion process, the interests of the debtor country, bank creditor, and investor must be balanced. Some of the reasons for Brazil's delay in implementing an active program until 1988 can be attributed to the following characteristics of the Brazilian economy:

1) Control of Brazilian Enterprises. Until 1987 considerable opposition to an active conversion program existed in Brazil because of the fear of excessive foreign control of Brazilian industry. In deciding which form of debt conversion would best avoid this problem, suggestions ranged from special mutual funds (holding only minority interests) to prohibition of foreign investor conversion.

2) Capital Market Capacity. This issue involved how much debt could be converted during any one time period. Over 1985 to 1988, the aggregate value of stock exchange listed shares ranged

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67. A. Parhizgari, Latin American Debt-Equity Swaps 6-10 (Dec. 29, 1987) (paper presented at the North American Economic and Finance Association Conference, Chicago, Illinois).

68. Indeed, at one point in 1987 the discount was as large as 60%. *Corretoras Americanas Procuram Alternativas para Regras Brazileiras*, Gazeta Mercantil, July 1, 1988, at 21.

69. On July 1, 1988, Brazilian debt paper was being quoted Bid 52-Ask 53 as a percent of face value. This quote is within the range of values for the previous 18 months of Bid 40-Ask 75, but below the price range for 1986. *Id.*

70. *Debt Rescheduling Accord Ready*, Gazeta Mercantil, June 27, 1988, at 3.

71. *See* Bresser Pereira, *Mudanças no Padra o de Investimento*, 8 REVISTA DE ECONOMIA POLITICA 20 (1987) (the author, a former finance minister, describes the key role played by external debt in limiting Brazil's economic growth prospects).

72. Winandy, *Conversão Formal Deve Atingir US$1.02 Bilhão No Semestre*, Gazeta Mercantil, June 16, 1988, at 23.

between seventeen billion dollars to forty-two billion dollars.[73] Conversion of one-fourth of the bank held debt could effectively denationalize the industrial sector and still leave a substantial external debt.

3) Discount on Existing Debt. Large discounts on debt conversion enabled purchasers of the debt to gain control of Brazilian productive assets at low prices. In effect, foreign investors could have enjoyed advantages over domestic investors seeking to invest in Brazilian industry. Moreover, the government could not give formal recognition to the discounted value of external debt.

While these preceding issues delayed the implementation of a formal program, economic necessity placed increasing pressure on the government to take action. The slow economic growth in the 1980s was attributed to low investment. Low investment activity, in turn, was partially associated with a lack of financial resources and with government delay in taking a more positive approach toward the debt problem and the economic imbalance.

B. *Conversions Before and After 1988*

The legal foundation of the conversion of external debt into risk capital extends as far back as 1965.[74] Formal conversions registered with the Central Bank were small in dollar amount until 1982, when a large secondary market developed. Formal conversions increased to $452 million in 1983, and to $700 million in 1984.[75] In 1987 to 1988 formal conversions climbed to $745 million and $2.5 billion, respectively.[76] Informal conversions which are not registered with the Central Bank are difficult to estimate, but they probably reached $800 million in the twelve months before June 1988.[77]

Decree No. 55,762 of February 17, 1965 had been the legal foundation for debt conversions until 1988. In 1978 and 1979, the government allowed incentives for converting debt into preferred shares of enterprises through the deductibility of dividends paid to

73. RIO DE JANEIRO STOCK EXCHANGE, BRAZILIAN MARKET NEWS, May 1989, at 3.

74. *See* Decree No. 55,762, art. 50 (1965). On the basis of this decree, formal and informal conversions of debt into equity took place throughout the 1980s.

75. *See* Winandy, *supra* note 72.

76. *Id.*

77. *Id.*

these shares.[78] These incentives came about as a result of Decree Law No. 4598 of 1977 and Decree Law No. 5654 of 1978.[79]

In 1983 and 1984, the government enacted new incentives for debt conversion. Decree Law No. 1994 of December 29, 1982 provided a financial credit of up to ten percent for contracts for the conversion of debt entered into before December 31, 1982. Central Bank Circular Letter 1125, from November 9, 1984 to July 28, 1987, stated that only the original creditor could be a candidate for investment through conversions, and only that original creditor's investment would be registered with the Central Bank at face value. This refusal to allow third parties to register investments at the Central Bank at face value was based on the concern expressed in some circles that the investor was gaining from a system, where little or no advantages accrued to the debtor country.[80]

New regulations required that in 1987 requests for conversion presented before July 20, 1987 had to be processed in accordance with the rules of Circular 1125 of 1984.[81] Requests received after July 20, 1987 would be processed under new rules to be issued in 1988.[82]

C. *Resolution 1460*

Until 1987, Brazil delayed installing a conversion program. There were practical reasons for this delay, such as potentially higher costs of servicing foreign equity investment as compared to foreign debt, political concerns of takeovers by foreign companies, and the possibility of narrowing the base of creditor banks.

Finally, in January 1988, the National Monetary Council established guidelines for a formal conversion program when it approved Resolution 1460.[83] Major guidelines of the Resolution are:

1) funds invested may be repatriated only after a twelve year period;[84]

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78. Monteiro, *A Conversão de Divida Externa Como Instrumento de Capitalização de Empresas*, 42 CONJUNTURA ECONOMICA 60-61 (1988).

79. *Id.*

80. *Id.*

81. *See* Banco de Boston, *Debt Equity Conversions*, in NEWSLETTER BRAZIL, May 30, 1988, at 2-3.

82. *Id.*

83. *Brazilian Swap Frontier*, Gazeta Mercantil, April 25, 1988, at 1-4.

84. *Id.*

2) dividends from a conversion (swap) investment may be remitted freely but are subject to the usual withholding tax;[85]

3) conversions are not permitted where the investor has a guarantee of fixed remuneration on the proposed investment because a fixed return is in discordance with the concept of risk investment;[86]

4) swaps will not be permitted where they transfer control of a company from Brazilian residents to residents abroad; however, this prohibition does not prevent foreign investors from increasing capital invested in existing foreign controlled enterprises or creating new foreign controlled enterprises;[87] and

5) profits from swap investments cannot be withdrawn for twelve years unless for reinvestment in Brazil.[88]

There are two distinct formats for conversion, namely, external debt already due for repayment, and external debt coming due in the future. In the case of external debt already due for repayment in 1988, twenty-five billion dollars was due and owing to creditors. Circular Letter 1302 deals directly with this portion of the debt. With respect to debt due for repayment, swaps can be carried out by monthly auction.[89] The first auction was held on March 29, 1988 at the Rio Stock Exchange with a ceiling of US $150 million to be converted.[90] Half of the equity auctioned monthly must be swapped into the high priority areas of the Northern and Northeastern regions.[91] The other half is used to build up swap mutual funds and for swaps in non-priority areas.[92] The first four auctions have alternated between the Rio de Janeiro

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85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. Monthly auctions involve bidders swapping debt into local funds for equity investments. The equity investments can be in a high priority area of the Northern and Northeastern regions, or in non-priority areas and to build up swap mutual funds (through which debt is converted into shares purchased on the stock exchange).

90. The US$150 million ceiling was established to limit the monetary expansion (usually inflationary) effects of the debt conversions. Nevertheless, in January, 1988, the monthly swap auctions were suspended temporarily due to inflation pressures. *Temporary Suspension of Auctions Does Not Stop Swaps*, Rio de Janeiro Stock Exchange, Brazilian Market News, March 1989, at 1.

91. *See* Banco de Boston, *supra* note 81, at 4.

92. These funds can be invested in any of the more prosperous southern provinces of Brazil, including Rio Grande do Sul, Paraná, São Paulo, Minas Gerais, and Southeast. *See* Monteiro, *supra* note 78.

and São Paulo Stock Exchanges.[93]

Under the second format for conversion, Circular Letter 1303 deals with the portion of external debt coming due in the future.[94] Of this external debt, US$32.4 billion is public sector debt and US$10 billion is private sector debt.[95] This debt may be swapped through direct negotiation between the foreign creditor and borrower at a discount that need not be revealed to the Central Bank.[96] The investment is registered with the Central Bank at an amount determined by using the average rate of discount established at the most recent swap auction.[97] By April 1988, the Central Bank had received close to US$2 billion in proposals for directly negotiated swaps.[98]

In 1988, the basic guidelines for swap mutual funds were defined.[99] Swap funds can raise capital from foreign creditors and fund managers that convert loans into the fund. There are certain "degree of control" restrictions on the amount a fund may invest in a single Brazilian company.[100] As of mid-1988, eight of the fifty-four swap funds that had been proposed and approved were operating.[101]

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93. At the first three swap auctions in 1988, the discounts bid on debt paper swapped were for free investment, 27% (March), 32% (April), and 22% (May); and for investment in needy areas, 10.5% (March), 15.0% (April), and 0.5% (May). *See* Winandy, *supra* note 72.

94. Circular Letter 1303, March 18, 1988. *See* Banco de Boston, *supra* note 81, at 2-3.

95. By June, 1988, the Central Bank estimated that it received US$2 Billion in proposals for swaps through direct negotiation. *See* Banco de Boston, *supra* note 81, at 2.

96. The cruzados simply change hands within the financial system and the investment is registered with the Departamento de Fiscalização e Registro de Capitais Estrangeros ("FIRCE"), the Central Bank department that registers foreign capital in Brazil.

97. Although the discount used in the transaction is undisclosed, the amount swapped is registered with the Central Bank at the average rate at the most recent swap auction. *See* Banco de Boston, *supra* note 81, at 3.

98. The Central Bank has no set limit to the amount of maturing debt that may be converted, except in the three cases: loans taken out by Brazilian banks for lending again to local companies under Resolution 63, loans taken out by borrowers looking for funding to repay maturing debts, and loans taken out by leasing companies under the terms of Circular Letter 600.

99. At least 70% of each fund's portfolio must be invested in private sector companies whose shares are publicly traded or in other firms that meet CVM requirements for similar characteristics. The remaining 30% can be invested in government securities or in open market operations. *See* Monteiro, *supra* note 78.

100. The portfolios of swap funds will be restricted to 5% of the voting capital or 20% of total equity in a company. *Id.*

101. Magalhães, *So Oito Fundos de Conversão Operam*, Gazeta Mercantil, July 23, 1988, at 1.

D. *Informal Conversions*

Informal swap activity has been an important aspect of debt conversions for many years. Informal swaps offer certain advantages. For example, domestic investors might not need to register their investment with the Central Bank for remittance purposes,[102] since those seeking short-term gains would have little interest in registration.[103]

Until 1988, participants could generate very short-term arbitrage profits due to the different percentage discounts or premiums on external debt in the secondary market, and on the dollar in the parallel (unofficial) foreign exchange market. This practice became common and is referred to as a "bicycle operation."[104] The basic problem with this operation is that it provided no lasting benefits for the debtor country. An agent-investor functioned as an intermediary, reaping profits from purchasing dollar debt at a discount, converting the debt paper into cruzados by surrender of it to the Brazilian debtor, and purchasing parallel dollars with the cruzados. An agent-investor would then continuously repeat this process.

On June 28, 1988, the Central Bank issued Circular No. 1326 to ensure that such conversions would be channeled into domestic investment.[105] The controls required that cruzados received from the informal conversions be paid into bank accounts, and that the bank notify the Central Bank of the deposit, original creditor, nature of payment, value of funds transfer in the foreign currency and local currency, discount, and money recipient.[106]

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102. Domestic investors could also benefit from any discounts on conversion funds available locally. Winandy, *Boa Vista Fica Com o Maior Lote*, Gazeta Mercantil, July 29, 1988, at 23.

103. Brokerage houses and banks can function as asset traders who specialize in negotiating assets on the international foreign debt secondary market. These banks form a link between creditors wanting to clean up their assets and companies wishing to buy loans at a discount and make a profit on the spread between the discount on the secondary loan market and that set at swap auctions. Horita, *Lloyds Investe no Banco US$55 Milhões de Divida*, Jornal do Brasil, June 28, 1988, at 11.

104. These "bicycle" transactions provided no basic economic benefits for the debtor country. In effect, the arbitrageur-intermediary generated profits based on varying discounts along the successive steps in the conversion process. *Conversão Informal da Divida Agora Tem Norma*, O Estado de São Paulo, July 1, 1988, at 26 [hereinafter *Conversão*].

105. In this case the Central Bank indicated it did not wish to interfere with the free application of cruzado proceeds from debt conversions, but to make certain that these cruzados would be utilized in Brazil. *BC Regulamenta Operações Informais*, Gazeta Mercantil, July 1, 1988, at 21.

106. *BC Baixa Normas de Controla Para a Conversão Informal*, Jornal do Brasil, July

VI. Privatization Program

Privatization in Brazil has its own, uniquely national character. It has emerged in response to economic need and general recognition that the private sector can operate more efficiently than the public sector in producing and delivering goods and services.[107] Defined broadly, the privatization program operated in Brazil on a limited scale for many years; defined narrowly, it began in 1988.

A. *Early Divestments*

Early divestments were carried out under the supervision of the CVM.[108] These divestments involved the sale of companies from the portfolios of regional development funds such as Fundo de Investimentos da Amazonia ("FINAM").[109] Approximately 3,000 companies were acquired by these regional funds as a result of fiscal incentives provided under various public sector financing programs.[110] For nearly ten years the CVM has arranged to dispose of these interests by auctions on the Brazilian stock exchanges. In such cases, CVM or the government has exercised no management role.[111] The companies involved are private sector oriented, and these auctions represent simple divestment by the government. These auctions are similar to a private placement, a divestment characterized by a limited number of bidders. Many of these companies are not registered with the CVM or stock exchanges because they are closed capital companies. No further trading of these shares is possible on the stock exchanges, unless the company has its capital opened through full disclosure and registration.[112] In-

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1, 1988, at 14.

107. Trevisan, *Estatais, Privatizar Para Não Sucatear*, 5 REVISTA DA CVM 8 (1987). Trevisan provides data showing that over the 1980s, state enterprises in Brazil experienced declining growth in assets, weak productivity trends, and low profitability. With respect to self-finance, state enterprises were able to generate one-third of resources required for their investment programs, with the remainder coming from borrowing and the federal treasury.

108. The National Securities Commission was given responsibility due to its interest in promoting development of the capital market. R. TEIXEIRA DA COSTA, BRAZIL'S EXPERIENCE IN CREATING A CAPITAL MARKET 53-55 (1985).

109. The regional development funds had assisted financing industrial development in their respective regions. In this role they acquired participations in many private sector enterprises. SUDENE, FISCAL AND FINANCIAL INCENTIVES FOR INVESTMENTS IN NORTHEAST BRAZIL 19-21 (1987).

110. Given the private sector nature of these companies, the term divestment is probably more appropriate than privatization.

111. Interview with Jose Breno Salomão, CVM officer, August 1987.

112. For example, Copene, a petrochemical company was auctioned and then after-

deed, only shares of open capital companies may be traded on the stock exchanges.[113]

A second type of auction, similar to the stock exchange auction, sells ownership of companies acquired by the National Bank for Economic and Social Development ("BNDES"). In many cases these companies became financially weak. There were limited alternatives to the BNDES taking control of them, since BNDES was a major creditor of these enterprises. In a BNDES takeover, the investment banking affiliate of BNDES ("BNDESPAR") often played a management role in these enterprises.

BNDES has usually disposed of these holdings in auctions conducted on the stock exchanges. An auction is one of several alternatives utilized by BNDES. Other alternatives involve closing down the company where profit prospects are very low; stock market sale where profitability is satisfactory; or a change of ownership (including sale to state governments).

In a typical auction, BNDES holds a majority of the company stock and auctions it to the highest bidder. The planned auction of Caraiba Metais is a prime illustration.[114] In July 1988, BNDES announced its intention to sell sixty-seven percent of the voting stock of this company.[115] Caraiba is the only producer of copper in Brazil, and approximately 140 companies purchase its output.[116] The Caraiba privatization is one of the largest privatizations undertaken by BNDES.[117]

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wards went public. After going public, Copene became a very large and successful company. RIO DE JANEIRO STOCK EXCHANGE, FACT BOOK 1989, at 16, 41 (1989).

113. *See supra* note 26, arts. 3, 53-55. Law No. 4728 established mandatory registration of securities issued and traded through the securities distribution system, and created tax incentives for companies to open their capital. *See also Conversão, supra* note 104.

114. An initial step in preparing the Caraiba privatization was to split the enterprise into two parts, a mining company and a copper processing company. The processing unit was offered for sale in the auction. Lupa, *Caraiba da Prejuico de US$1 Bilhão ao BNDES*, Jornal do Brasil, July 4, 1988, at 22.

115. In preparing the auction, BNDESPAR limited foreign ownership to 16% of the capital with direct vote. To widen ownership of the company (also known as pulverizing capital), a second distribution of Preference Shares was scheduled. Prior opportunity to purchase these shares was designated for 116 consumer companies that purchase copper from Caraiba. *Id.*

116. Eight large customers purchase over 50% of production. These customers protect the smaller customers by selling them non-voting stock. This ownership gives the smaller customers the power to decide how to divide up to 20% of the production of Caraiba. *Id.*

117. As of January 31, 1988, total assets of Caraiba Metais were valued at US$439.7 million. *Id.* This information was made available by BNDESPAR in a fact sheet which it generally provides in the case of privatizations.

B. *Council for Privatization*

Pre-1988 sale of share participations by CVM and BNDES were mainly divestments and not privatizations. These divestments represented share investments acquired either during financing of priority sectors, or bailing out companies experiencing financial difficulty.[118] In 1985, a new initiative emerged when President Sarney issued Decree No. 91,991.[119] This decree established an Interministerial Council for Privatization and indicated enterprises under government control would be included in a privatization program.[120] Certain types of companies were specifically not included in the proposed program in particular where national security was involved, and where a legal monopoly was required.[121] By 1987, the Interministerial Council established a portfolio of sixty-five state enterprises to be privatized. The portfolio included twenty-five percent of state enterprises in the productive sector.[122]

On March 29, 1988, Decree No. 95,886 was issued.[123] The 1988 Decree adopted a broader approach to privatization, deregulation, and "desestatização."[124] The name of the Council was changed to Conselho Federal de Desestatização, to reflect this broader approach. In mid-1988, the Council issued its own plan of action which called for:

1) a variety of methods to implement its program, including opening the capital of enterprises, adding to the capital of firms by sale of share participations, or dissolution of firms;

2) standard procedures such as publishing minimum prices in

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118. Regarding companies experiencing financial difficulty, BNDES, a major creditor of the company would acquire a controlling interest, or even complete ownership. In 1988, BNDES was approaching a position where it had only 3 or 4 companies in this status remaining to be divested. *Id.*

119. Decree No. 91,991 of Nov. 29, 1985, *reprinted in* J. CODIMEC, PRIVATIZAÇÃO, MERCADO DE CAPITAIS E DEMOCRACIA 352-56 (1988).

120. The Interministerial Council was assigned broad authority to initiate conditions and criteria for privatization, subject to general requirements of broad disclosure of activities, use of market facilities (including stock exchanges), use of external auditors, and a requirement that control was reserved to Brazilian residents or firms. *Id.*

121. *Id.* art. 4.

122. Moreira, *supra* note 12, at 334.

123. *A Integra de Projeta de Desestatização Preperado Pelo Governo*, Folha de São Paulo, June 10, 1988, at 3.

124. The term "desestatização" refers to a transfer to the private sector of services which can be provided indirectly; extinction of agencies providing economic services; and disposition of assets or enterprises that provide services that can be provided alternatively by the private sector. No term in English adequately conveys the full meaning of this word.

the sale of enterprises and publicly disclosing privatization activities; and

3) professionals or specialized firms to be used for consultation, audits, and distribution of shares.[125] The Council's plans as well as the debt conversion and privatization programs are expected to stimulate the venture capital industry in Brazil and promote further development of the capital market.

VIII. Venture Capital Industry in Brazil

A. *Emergence of Venture Capital Industry*

The Brazilian venture capital experience is fairly recent. Given the economic environment in Brazil, a number of firms in this industry have patterned their activities along the *banque d'affaires* model. Recent legislation gives specific guidelines and tax incentives. As of July 1988, fifteen venture capital companies were operating in Brazil,[126] with an estimated $150 million of capital investment.[127]

Decree No. 2284 and Resolution 1184 of September 4, 1986 legally established venture capital companies.[128] These companies may invest their own resources in the securities of small and medium size Brazilian companies and, at times, bring other investors into the financing project. Venture capital companies generally focus their activities on the industrial sector, as they are not permitted to invest in financial institutions and certain other types of companies.[129]

Decree Law 2284 and Resolution 1184 grants important incentives for venture capital activities, including:

1) tax-deductibility of dividends paid by the investee company

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125. *Id.*

126. Included among these companies are Citicorp Venture Capital, Brasilpar Comércio e Participações (operating since 1980), Arbi Participações, Companhia Riograndense de Participações, Credibanco Participações, Acel Investimento, Partbank, and Brazilian Venture Capital ("BVC").

127. *See infra* app., table 3. This figure does not include the capital of BNDESPAR, which in many respects operates as a venture capital company by taking temporary participations in growing companies.

128. Resolution 1184 followed Decree Law No. 2284. *See supra* note 51 and accompanying text.

129. For instance, venture capital companies are not permitted to invest in financial institutions, and certain other type companies.

to the venture capital investor are for the dividend paying company;

2) exempting venture capital companies from paying taxes on dividends received and capital gains originating from divestment or liquidation of participations; and

3) taxing at a rate of twenty-three percent, venture capital company stockholders, the proceeds received and the capital gains originated by the liquidation or sale of the participation company are taxable at the rate of twenty-three percent.

Considering the normal income tax rate in Brazil in 1988 was forty percent, up from twenty-five percent in 1985, these incentives are formidable indeed.

Although the venture capital industry is a recent phenomenon, numerous characteristics of Brazil can contribute to its success and growth. First, there is a strong entrepreneurial culture in Brazil which is based on a sense of dedication, initiative, hard work, and willingness to take risks.[130] Second, current securities law provides an appropriate environment for venture capital. Law No. 6404 of 1976 covers all investment instruments that could be used and are currently used by venture capital companies in Brazil such as preferred stock, cumulative and non-cumulative preferred, convertible preferred, subordinated and convertible debentures. Third, while ordinarily technological investment involves high research and development costs and high risks in terms of applicability, success, and marketing, in Brazil these risks and costs are lower because technology projects, already used successfully in mature economies, can be transferred easily to Brazil. Any remaining risks are centered on people, timing and finance, which are more manageable and assessable risks than any risks involved in new technology applications and marketing. Fourth, the existence of a developed stock market permits developing investment participations through public offerings. At present, there are 1,000 publicly held companies, of which 650 are registered on the stock exchanges.[131] Finally, Brazil provides interesting investment opportunities because of its rapid development, population of 140 million, and its rank as the eighth largest economy in the world.[132]

130. The number of new business initiatives organized during the plano cruzado (from March 1986 to May 1986, 113,000 new companies were organized) is an indication of this spirit. *See* R. Teixeira da Costa, *supra* note 57.

131. *See* R. Teixeira da Costa, *supra* note 108, at 14.

132. Int'l Bank for Reconstruction & Dev., World Bank, World Development Re-

Venture capital companies can provide capital and financial services for small and medium size enterprises that will contribute to the creation of a strong domestic economy. Debt-to-equity swaps by foreign bank creditors offer the financial support necessary to facilitate the access of venture capital to long-term resources in the capital market.

B. *Special Risk Taking Funds*

Venture capital activity focuses on channeling funds into risky investments. The establishment of specialized investment vehicles, capable of assuming and diversifying risks for participating investors, is an important way of facilitating this channeling of funds. In recent years, several types of specialized funds have been created especially for this purpose.[133]

A large number of debt conversion funds have been organized since February 1988, when Resolution 1460 came into effect.[134] The Central Bank and the CVM have defined basic guidelines to create swap funds aimed exclusively at buying shares in companies located in the needy Northern and Northeastern regions. In such cases, at least seventy percent of each fund's portfolio must be invested in private sector companies whose shares are publicly traded.[135] The remaining thirty percent can be invested in government securities or open market paper.[136] In all swap funds, the value of shares of each portfolio cannot exceed five percent of the voting capital or twenty percent of total equity in a company. Swap funds can obtain capital in two ways, namely, foreign creditors may buy shares in the fund by converting their loans at scheduled auctions, and fund managers themselves may convert their own loans into a portfolio of stock held by the swap fund.[137]

Fifteen foreign capital investment funds were in operation in Brazil during 1988.[138] These funds were invested primarily in the share market, but also allocated funds to other types of securities,

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PORT 1989, at 164-65, 168-69 (1989).

133. See *infra* app., table 3 which compares specialized funds according to number, sources of funds, and investment objectives.

134. *Id.*

135. *See* Monteiro, *supra* note 78.

136. *Id.*

137. *Id.* at 8; *see also Funds for Amazon, Northeast*, Gazeta Mercantil, Apr. 25, 1988, at 8.

138. *See infra* app., table 3.

including federal government bonds and bank certificates of deposit. Three types of vehicles are authorized according to Resolution 1289.[139] One vehicle, the Managed Portfolio of Bonds and Securities (Brazil Fund), was established early in 1988 and distributed in the United States. The Brazil Fund is subject to the provisions of the Investment Company Act of 1940.[140]

In 1988, Circular 1339 was issued,[141] providing for the establishment of Foreign Investment Companies. In this same year, only one of these companies existed, namely, Equitypar Companhia de Participações. Equitypar may only invest in the primary share market and not in the secondary market, unless it takes a minimum of five percent of the capital of the company, a non-speculative role. Investee companies may use funds for expansion, modernization or financial restructuring purposes. It is expected that participations of Equitypar will be more permanent and the portfolios of Foreign Investment Companies will be less volatile than Debt Conversion Funds.

Equitypar was organized and is managed by Brasilpar Serviços Financeiros Ltda. ("BSF"), a financial services company with experience in managing industrial and venture capital investment funds in Brazil. BSF applied to the Central Bank of Brazil in July 1987 for authorization to launch Equitypar.[142] Equitypar is a Brazilian portfolio company whose purpose is to invest in a selected number of medium and large industrial and commercial companies, offering investors a suitable return consisting of a steady flow of dividends and realized capital gains.[143] In order to provide capital for Equitypar, a two tranche capital offering was structured.[144] Since the application for Equitypar was made prior to July 20, 1987, investors choosing this debt conversion vehicle will benefit

139. *See generally id.*

140. *See* BRAZIL FUND, *supra* note 64, at 5.

141. BRASILPAR SERVICOS FINANCEIROS LTDA., BANQUE PARIBAS, OFFERING SUMMARY, EQUITYPAR COMPANHIA DE PARTICIPAÇÕES 1-2 (1987).

142. *Id.*

143. *Id.*

144. *See infra* app., table 4. The capitalization of Equitypar on July 1988 was: First Banque Paribas, US$42.0 million; Banque Sudameris, US$10.0 million; First National Bank of Chicago, US$10.0 million; Morgan Grenfell & Co. Ltd., US$10.0 million; Banco del Gottardo, US$5.0 million; Banque Internationale a Luxembourg, US$3.0 million; and second tranche Banco Financeiro e Industrial de Investimento S.A., US$2.5 million. It is reported that the International Finance Corporation may participate in Equitypar as a minority stockholder. *Equitypar in Business*, Gazeta Mercantil, July 11, 1988, at 6.

from the rules of Carta Circular 1125[145] issued by the Central Bank which permits full registration of converted amounts, not discounted values, of foreign capital for purposes of dividends and capital registration. Investors must agree to maintain their capital investments in Brazil for a period of twelve years.

Equitypar intends to follow an investment strategy which includes minority participations in dynamic and well managed companies. The average maturity of investments will be geared to achieve an annual turnover of approximately twelve percent.[146] Equitypar aims at financing approximately twenty projects which will be allocated an average of five million dollars. Not more than twenty percent to thirty percent of the funds portfolio will be invested in one project and one sector.

Thus far, Brazil has succeeded in stimulating the development of a growing number and variety of investment funds. All of these funds operate in the venture capital field. These special investment vehicles can play an important role in the debt conversion and privatization programs formalized in 1988.

VII. Conclusion

Both debt conversion and privatization offer opportunities to expand and deepen the Brazilian financial markets. Debt conversion should permit some enterprises to reduce their total debt outstanding, which will make their remaining securities more attractive to investors in the capital market. More important, debt conversions can create liquid capital for investment activity, thereby increasing the amount of risk capital available to Brazilian enterprises. Further, conversions can stimulate and finance higher levels of foreign investment in Brazil. In fact, one study reported that in the five year period between 1983 to 1987 conversions provided between thirty-four percent and sixty-one percent of funds invested in Brazil by foreign investors.[147] Conversions can also supply liquid capital to swap funds which seek to make venture capital investments. In addition, private placement funds attract creditor banks and other foreign investors. Private placements are created without public offering, but are registered with the CVM.

145. *See generally Funds for Amazon, Northeast, supra* note 137.
146. *Id.* at 4.
147. *See* Monteiro, *supra* note 78, at 61.

Privatization can be structured to make extensive use of the capital market. The auction of controlling interests in an enterprise to an investor group mobilizes resources and helps to develop the capital market. More important, requiring the investor group to open the capital of the enterprise assures fuller development of the capital market. A pulverization of capital, distributing shares widely to employees and public investors, accords maximum opportunity for expansion of the stock market.

Overall, privatization and debt conversions can be mutually supporting activities on the capital market. Debt conversions can liquify capital for investment in Brazil, especially since the availability of liquid capital is a requirement for carrying out privatization. At the same time privatization stimulates a demand for liquid capital. Although it is too early to judge how beneficial these programs will be for future development of the Brazilian capital market, the prospects are nevertheless promising.

APPENDIX

Table 1: Portfolios of Capital Market Institutions
(Millions of Cruzados)

Year	Private Pension Funds (Closed)	Share Mutual Funds	Insurance Companies	Fixed Income Mutual Funds	Private Pension Funds (Open)	Societies for Foreign Investment	Total
1985	60,090	17,970	9,976	21,056	1,818	325	111,235
1986	91,270	31,614	16,705	12,892	2,975	512	155,968

Source: Central Bank of Brazil

Table 2: Capital Invested in Mutual Funds, Feb. 12, 1988.
(Millions of Currency Units)

Type of Fund	Number of Funds	Invested Capital Cruzados	US Dollars*
Share Funds	142	142,324	890
Fixed Income	89	203,654	1,270
Short Term	64	977,608	6,110
Total	295	1,323,586	8,270

* Obtained by using exchange rate of Cz$160 per U.S. dollar.

Source: Jornal de Brasilia, July 7, 1988, at 6.

Table 3: Main Features of Brazilian Investment Funds - 1988

Type Fund	Applicable Legislation and Regulation	Number of Funds Organized and Operating	Source of Funds and Amount Invested (Millions)	Investment Objective
Debt Conversion	Resolution 1460 Feb. 1, 1988	Organized 54 Operating 8	Debt Conversion	Channel Funds Released From Debt Conversion Into Venture Capital
Foreign Investment Companies	Circular 1339 July 26, 1988	1	Debt Conversion; Other Foreign and Local ($85)	Permanent Type Investments
Foreign Capital	Resolution 1289	15	Foreign Investor	Diversified Securities

Investment	Mar. 20, 1987		($512)	Portfolio
Managed Portfolio of Bonds and Securities[1] (Brazil Fund)	Resolution 1289 Mar. 20, 1987; Investment Company Act of 1940[2]	1 in U.S.	Foreign Investor ($150)	Long Term Appreciation Through Investment in Securities Portfolio

Table 4: Two Tranche Capital Offering of Equitypar.

Tranche	Total Capital	Minimum Subscription	Source of Funds
1	$30	$5-10	External Debt Conversion
2	$20	$2	Direct Foreign Investment and Domestic Funds

1. Information refers to Brazil Fund, launched in March 1988 with shares distributed to U.S. investors.
2. Brazil Fund was incorporated in Maryland as a non-diversified closed end investment company, registered under the Investment Company Act of 1940.