THE BRAZILIAN STOCK EXCHANGE FROM ORIGIN TO THE ENTRY OF FOREIGN CAPITAL

JOSEPH K. TUCKER
FRANK J. FABOZZI

AFTER World War II, Brazil faced a ruinous inflation, a rapid nondirectional growth of industry, and the absence of an effective capital market to further its national and international interests. Inflation fed the boom in the postwar years. It was the "unregistered" underwriter of the economy. The mechanisms evolved for the control of inflation and the emergence of a capital market plan produced a need for a stock exchange system.

This work proposes to bring into historical perspective the 185 years between the loose organization of a rudimentary trading exchange and the Bolsa de Valores, the Brazilian Stock Exchange, of 1975. The development of the market took place in stages directly related to regulatory acts on the part of the government. Generally, this has been the history of the evolution of all the security exchanges. The establishment of Brazil's capital markets parallels the turbulent history of the country itself and presents many innovations which might be applied to the economics of the developing countries of the world.

The protective nature of the early decree laws to be described followed a sequence not unlike those in the United States, leading to the formation of the Securities and Exchange Commission. The machinations within the financial community of the 1920s and 1930s that characterized our early boom-and-bust blue-sky excesses were repeated with variations in Brazil.

The introduction of foreign capital into Brazil, in the form of debt-equity instruments with relative freedom of international flow, is the end-point sought for a free market. Among the less developed countries, there exists a delicate balance between the problems of internal control and the need for an easing of restriction on outside investment. The free entry and departure of foreign capital, while a desirable end in itself, exists nowhere at this time. In the United States, there are limitations on investments for foreigners in certain industries, and a close watch is kept on foreign money movements. It is not inconceivable that any significant foreign influx into the United States market would call forth legislation for control.

Against this background, we will appraise Brazil's regulatory atmosphere and the end product of its capital market formation—the introduction of foreign capital. This is a dynamic process upon which a final judgment is patently impossible. A continuous evaluation, dependent on international, social, political,

and economic policy, will be the means for the measurement of its success.

A. *Capital Market Technologies*

The utilization of savings and its mode of distribution determine the direction of economic development. Two alternatives present directly: the evolution of a free market, or finance by fiat. Trubek [26, pp. 9–11] and Harris [9, p. 80] make use of the Gurley-Shaw model [8, p. 257] of alternative "technologies" for the mobilization of surplus and the means of capital formation in the development of a capital market.

The four "technologies" are *taxation, self-finance, foreign aid,* and the *debt-asset system of finance. Taxation* involves finance by fiat, the creation of agencies of government for allocation, and the attendant difficulties inherent in an all-powerful bureaucracy. *Self-finance* encompasses price controls or inflation. Relative prices must be moved in the direction of the investing sector. *Foreign aid* acceptance brings multinational corporations, foreign government intervention in internal affairs, and a generalized weakening in national economic pride. The *debt-asset system* tends to be the most highly developed, needs the finest tuning, and involves the "creation of financial assets which are held voluntarily by economic actors" [26, p. 12].

The four technologies are not mutually exclusive; each has advantages and disadvantages at different times, and depends on the state of the economic institutions within the nation. If the tax structure is weak and nonenforceable, taxation becomes a poor alternative. The debt-asset system is the most sophisticated and requires a degree of confidence in the extant economic system, a stable banking atmosphere, and a body of law sufficient to protect those who would part with their savings in the expectation of future gains. The establishment of a primary market is basic. However, the aftermarket, a trading market in outstanding shares, with attendant liquidity for buyers and sellers, is all-important. The changing preferences of the investor in this secondary market for the outstanding (circulating) corporate equities define the width and breadth of the market. No capital market development is possible or meaningful without a free and unhampered "auction" atmosphere.

Expansion of the private sector within the economy for the Latin American countries in the post–World War II years came from self-financing and foreign sources. Equity capital contributed little. Table I shows the low state of capital market development for the private sector, with Brazil second only to Chile in the amount of *non-equity* capital.

David T. Kleinman, in his testimony before the Foreign Affairs Committee of the House of Representatives, presented an overview of the capital market development of the less developed countries, emphasizing the problems of long-term capital lending, its sources and its effects [13]. In an incisive description of the present model, he points out:

(1) The short supply of long-term capital due to the absence of a liquid capital market.

(2) When aid was to come from external sources (World Bank, Agency for

TABLE I

FINANCING OF INVESTMENT IN PRIVATE, LOCALLY CONTROLLED MANUFACTURING ENTERPRISES: SELECTED LATIN AMERICAN COUNTRIES

(Percentage Distribution)

Country	Period	Self-financing			Sources Outside Firm		
		Total	Undistributed Profits	Depreciation	Total	Equity Capital	Other Sources
Argentina	1960-61	40.0	14.0	26.0	60.0	9.0	51.0
Brazil	1959-62	43.2	36.4	6.8*	56.8	8.2	48.6
Chile	1949-61	52.3	42.3	10.0	47.7	4.5	43.2
Colombia	1958-62	51.8	27.8	24.0	48.2	16.4	31.8
Ecuador	1953-57	56.5	22.7	33.8	43.5	12.6	30.9
Uruguay	1960	42.0	—	—	58.0	16.0	42.0
Venezuela	1961	50.5	21.3	29.2	49.5	10.6	38.9

Source: Donald L. Huddle, *Inflationary Financing, Industrial Expansion and the Gains from Development in Brazil*, Program of Developmental Studies Paper No. 60 (Houston, Tex.: Rice University, 1975), p. 5.

* This figure is unduly small and probably is explained by the accelerating inflation under which firms could only depreciate at original cost. See United Nations, ECLA, *The Process of Industrial Development in Latin America*, No. 66.1164 (New York: United Nations, 1966), Table 35.

International Development), the time lag and the minimal competitiveness in channeling funds through local private banks with favored customers.

(3) Loan projections from borrowers and their experts produced what could be characterized as a "monetary-overkill." Rarely did they project a conservative need for funds. Because rates were low and inflation on the increase, there was no incentive to prepay any of the monies and release the funds for aid to others.

(4) The closely held nature of the companies in the less developed countries resulted in an outflow of capital. Private individual investors within the country, and individuals in the "venture capital" countries were not encouraged because of lack of a liquid market.

(5) When no capital market exists, the so-called efficient market, which would help pick and choose prospering industries for allocations by merit, does not surface.

As a result of his study of the model that existed in the early 1960s in Brazil and other less developed countries of Latin America, Kleinman presented two seminal papers [11] [12]. Later, at the invitation of the Castello-Branco government, these concepts were incorporated into Brazilian law, becoming the basis for FUMCAP, known as the revolving Capital Market Development Fund within the Central Bank of Brazil.[1]

[1] FUMCAP was to be funded, in part, by a loan from the Agency for International Development (AID). The loan, in the amount of $15 million, was the subject of a lengthy report to the Department of State [12], crediting Kleinman's 1968 paper as having had a catalytic effect on the United States Agency for International Development (USAID) programs in the capital market.

B. *Inflation*

For Brazil, inflation was a post–world war phenomenon. Brazil emerged from World War II little better financially than it entered. The attempt by this relatively underdeveloped country to catch up with the great powers resulted in a disastrous inflation. With further democratization of Brazil came an increase in inflation. Each new political leader increased his popularity and the country's indebtedness concurrently. The excess of federal expenditures over receipts was the most direct cause of the inflation.

Brazil's inflation averaged about 15 per cent per year from 1949 through 1955. In 1956, Kubitschek, the builder of Brasilia, became president. During his five-year tenure, the annual inflation rate increased by 60 per cent. From 1961 through 1966, there was great political ferment, pointed up by the revolution of 1964. In 1964, the inflation rate was up to an annual rate of 140 per cent. Brazil was now a victim of the printing press, with inflation reaching catastrophic proportions. Using 1949 as a base year, prices equal to 100 per cent, the annual percentage increase by 1966 had driven up the multiplier to 8708 per cent.

Coincident with the peaking of the inflation came the revolution of 1964. The Castello-Branco government of 1964 came to power with a promise of economic and social reform, with capital market development given high priority. The inflationary trend was to be reversed through tax reform and financial market reform as alternatives to inflation. However, inflation continued and as a result the government in 1967 decreed the *new* cruzeiro, equalling 1,000 *old* cruzeiros. This "reverse split" made figures more manipulable, and removed at least temporarily, and nominally, the specter of the postwar German and Hungarian-type inflations.[2]

C. *Monetary Correction or Indexing*

The application of monetary correction (MC) or indexing[3] is a mechanism by which the nominal value of a claim is adjusted to compensate for the loss in purchasing power of the currency in which that value was originally expressed. The application of MC in Brazil can be traced back to 1951, when firms were first authorized to correct the historical value of their fixed assets.[4] This development, which came to be known as "reevaluation of assets," was in 1958 authorized to be applied on a regular basis, and the legislation that followed extended the application of MC to current assets.

From 1964 on, the use of MC was considerably expanded. By 1970, practically every claim could legally have its value corrected. In 1964, there was created ORTNS (readjustable government bonds) and housing bonds (*letras imobiliarias*), both with MC. MC was authorized to be charged against private credit instru-

[2] Recently, a 37.1 per cent inflation rate for a twelve month period was reported, the largest for any such period since 1968.

[3] For a discussion of Brazilian indexing see [6] and [4].

[4] The Alice-in-Wonderland aspects of Brazilian accounting practices are described in [14, pp. 49–53].

ments such as bonds, time deposits, and bills of exchange. The government's objective in extending MC to financial instruments was to improve its own ability to borrow in the long-term markets, and to encourage a private long-term financial market in Brazil. A natural consequence of instruments without MC was their elimination as vehicles for long-term borrowings.

Throughout the inflationary period, Brazil clung to the 12 per cent limit as a ceiling for the so-called usury law. However, in practice, it was circumvented by the use of surcharges, commissions, discounting, and rebates in cash. The wealthy investor was interested only in the short-term instrument. MC was the compromise when a solution was sought for the conciliation of long-term financing and the prospects of a high inflation rate.

D. *Early Essays at Regulation*

The evolution of the market parallels its legal development, and the role of law must be considered a prime determinant of investment incentive. After the 1843 law requiring licensure for dealing as a stock broker, the balance of nineteenth century legislation was relatively meager, and, while it made reference to "regulation of the profession," was not substantive. Decree Law 648, of November 10, 1849, was intended to regulate brokerage throughout the (then) Empire of Brazil. There was established a quota—a fixed number of brokers for each region—and a board was authorized to regulate admissions to the "profession."

Poser notes that no meaningful action was taken to reform the 1849 law until 1966. The market still operated with a limit of fifty brokers each in Rio and São Paulo. These hereditary "seats" could be passed on to the sons of the holders, constituting an officially sanctioned monopoly. The 1966 actions of the National Monetary Council encouraged membership in the stock exchanges for credit, finance, and investment companies [16, p. 1291].

In the 1890s, there was an attempt, by decree, to limit the laissez-faire excess of the market, an official creation by law of the Stock Exchange of the Republic, and the promulgation of basic rules for the conduct of exchange business. Stock dealings, per se, were not the major source of revenue for the brokers. Until 1963, the foreign currency exchange business was most lucrative, and a very thin market resulted for trading of corporate shares [2, p. 3]. Because of this, any corporation issuing equity for capital growth was at a disadvantage, because secondary markets did not exist. The absence of secondary markets will be returned to, time and again, as a prime deterrent to capital market formation.

The years 1900–1930 constituted another sterile period in regulatory activity. In 1939, Decree Law 1344 proposed that membership in the exchange would be decided through public bidding by brokers [2]. This was an effort to enlarge the number of brokers as such, but still limited membership in the exchange, continuing the exclusion of institutions and other entities until 1966.

Brazil's political institutions were important determinants of the direction securities regulation would take. A historic perspective, touching on any aspect of government, must deal with the problems of decentralization versus federalism [7, pp. 195–96]. Significantly, Decree Law 24275 of 1934 extends control past

the federal districts to regulation at the state level. This law extended the range of control to areas heretofore not under effective supervision.

E. *Restructuring after 1964*

Another lengthy regulatory hiatus occurred between 1934 and 1964. Law 4595 created the National Monetary Council. The council was brought into existence after the revolution of 1964. The enabling law, 4595, defined the functioning financial institutions as those authorized and created by the Central Bank. The law also established uniform balance sheets and income statements for financial reporting [2, p. 3].

Traditionally, Brazil's industrial complexes have been closed clubs. Strong family ties encourage close control, strong strains of nepotism prevail, and only with a new generation of entrepreneurs will "going public" have any meaning [16, p. 1287fn.].

Poser [16, p. 1287] makes the point that the "Modern Corporation" of A.A. Berle [1, p. 169] does not, to this day, exist in Brazil, with attendant separation of ownership and management. Laws encompassing rudimentary provisions for disclosure are meaningless in practice because of confusion in auditing, accounting, and accessibility to figures of the "fiscal council" established by the law. Roth [20] points out that Decree Law 9783 of 1946 requires filing of reports with a stock exchange, but there is no provision for a review of the reports. Although there was a requirement for registration of stock to be traded on the exchange, there was no legal impediment to trading the securities off the exchange. Until 1959, there was no required registration of investment companies, mutual funds, or their sales personnel. Decree 309 in that year was the first to require registration, diversification of portfolios, and minimal capital requirements. Before the enactment of the Capital Markets Law of 1965, investor protection was limited by Decree 309.

The issuance of participating preferred shares was a mechanism for raising capital for domestic corporations, without risk of loss of control. Decree 4390 of 1964, amending 4243 of 1962, precluded foreign corporations from doing so, but did nothing to stop the domestic corporations from going this route [20, p. 1281fn.].

The development of the capital market structure through law proposes a system that regulates the underwriter and the form of the underwriting, including the professional sales force, and the market in which the trading takes place. The Capital Markets Law of July 14, 1965—4728—is the basis for the restructuring of the Brazilian trading markets. It defined membership regulations, established a guarantee fund against differences due to inaccuracies in execution, and (predating the Securities Investor Protection Corporation of the New York Stock Exchange) insured against fraud on the part of participating member firms [20, pp. 1282–83]. There followed a number of modifications and additions to the law, relating to the organization of the exchange, admission of new members, accounting standards, underwriting requirements, definitions of round lots and trading rules, and corporate standards for listing eligibility.

The previous list of obligatory regulations is faintly reminiscent of commentary in the financial press of this country on the subject of controls. In 1966, the Alliance for Progress Program of the State Department sponsored the NYU Graduate School of Business as advisors to the Bolsa, and if the regulations are somewhat familiar, the reasons are evident [19, p. 14]. The Capital Markets Law was based on the U.S. Securities Act of 1933 and the Securities Exchange Act of 1934.

F. *Evolution of the Open Capital Corporation*

The creation of the "open capital corporation" by Decree Law 4506 of 1964 was a method of capital market development using tax incentives as the moving mechanism for creating and encouraging equity investment. Trubek describes the efforts of the Castello-Branco government in the creation of the SCAs (Sociedade Anonima de Capital) as the first attempt at the "democratization of capital" [26, p. 12]. The SCA provided tax incentives for the corporation and the shareholder in the form of exemptions and deductions.

In the 1964 postrevolution effort to combat the mounting inflation, the strict credit policy had to be modified to avoid corporate fiscal strangulation. The creation of FUNDECE (The Fund for the Democratization of Capital of Corporations) by Decree Law 54105 of that year attempted to direct funding to those industries which would sell shares to the public, produce goods for export, or eliminate economic "bottlenecks." The FUNDECE concept was not successfully implemented because of difficulty in marketing of the new shares. Public interest was low and underwriting costs were high. The FUNDECE loan regulation was satisfied by subscription of the amount of the loan by existing shareholders. This accomplished a recapitalization, but not a wider distribution of the shares. The "democratization" was minimized, if not eliminated.

SCA Law 4506 extended the democratization by exempting complying companies from a surtax on distributed profits, providing it met requirements involving negotiability, distribution, substantial public ownership, and continued expansion within the equity market. New additions and resolutions to the SCA law modified the concepts of distribution and ownership with voting rights, to emphasize negotiability. Resolution 16 of 1966 eliminated the requirement that the public hold voting shares, lowered public participation requirements, and generally weakened the original intent by a supposed emphasis on negotiability. Resolution 16 was completely unsettling to the SCA law. It attempted to enlarge the amount of funds available for rapid corporate expansion, but reversed the "democratization" process by allowing a reconcentration of control. This was effected by loss of voting rights, increasing family control as previously noted, and discouraging further investment.

In 1968, Resolution 106, issued by the Central Bank to modify Resolution 16, completely changed eligibility rules for SCA-aspiring corporations.

Basic requirements dictated public ownership of 20 per cent of the common stock with a standard for a minimum number of shareholders, a mandatory increase in public shareholders until 49 per cent of the common stock was publicly

held, and negotiability in the form of registration on at least one of the extant stock exchanges. No corporation could limit the free sale of its stock in any manner.

The form of tax benefit was attractive to potential SCA equity holders and corporate issuers. The taxpayer could deduct 30 per cent of SCA stock purchases from his gross income, up to 50 per cent of gross income. Dividends could be withheld at the source, taxed at 15 per cent, instead of the usual 25 per cent for the non-SCA, or "closed" corporation, and remain in the form of bearer shares, so popular in Brazil for the preservation of anonymity. An alternative for registered shares was to receive them tax-free and include them in the tax return, with a monetary exemption granted. The SCA corporation benefitted under Law 106 by an exemption from a surtax on dividend distributions, and could also deduct part of the payments from its gross income. These benefits were available to all SCA stockholders, without reference to the class of stock, or whether it was bought in the primary or secondary market.

The Open Capital Corporation was the subject of a complex set of rules, often contradictory in nature, but which has as its goal a broad distribution of shares. At the onset, the broadening of the ownership base, primarily through the *transfer* of shares, was emphasized. The opening could be effected over a period of eighteen years, shifting control toward the 49 per cent goal very slowly, enhancing the price of the stock through its tax advantages to the purchasers, and encouraging transfer transactions, rather than issuance of new shares. The distribution of common shares with voting rights was an important deterrent to the formation of further SCA corporations. The exercise of political power through corporate ownership was threatened by liberalization of the structure through the grant of voting rights. Government policy made restructuring a priority to involve the general population into an "agrarian capital reform." The economic target, with the issuance of voting stock as its center, involves the continuing debate on corporate responsibility to the stockholders: with little voice, the stockholders receive little in the way of dividends. A byproduct of the economic good is the minority voice in corporate affairs as tending to increase responsibility on the part of major stockholders.

As a final benefit from the mix produced by the democratization and economic enhancement in the form of dividends, it was hoped that management would become more responsive, more responsible, and more efficient. These factors are the ultimate goal for the promotion of the system as it was envisioned in Brazil. Until 1971, the speed with which the "opening" was progressing was deliberately slowed by the reluctance of the corporations to issue voting shares. Resolution 176, modifying the Open Capital Law, allowed issuance of 20 per cent voting shares, and the balance in either voting (common) or nonvoting (preferred) shares.

The SCA system for investment, as a method of channeling savings, was a highly optional method, with promise of tax savings as the reward for investment.

G. *Decree Law 157 (DL 157) Alters the "Technology"*

The Open Capital Corporation Laws (SCA) were not sufficient to effect a broadening in the equity ownership base. While the tax incentives under the SCA law were attractive, they appealed more to the investment proclivities of the high-bracket investor, were entirely voluntary, and competed in the market with short-term high return instruments.

Decree Law 157 modified the debt-asset technology of the Gurley-Shaw model by the introduction of a forced savings feature, entirely beneficent, but which could work only in a fiat-oriented economy. As originally constituted in 1967, Decree Law 157 allowed the taxpayer a tax *credit* of 100 per cent for his indication of the investment of a stated, allowed sum in a fund created to receive and invest the money. It was an unusual and enlightened move, in that it was a deduction from the tax itself, and not from the taxable income. The taxpayer had only to request a voucher from the taxing authorities and forward the voucher to the mutual fund of his choice. This was to be an educational experience in investment saving at no cost to the investor.

In spite of this "philanthropical" attitude on the part of the government, many did not avail themselves of the opportunity. After a few years, the Brazilian Federal Revenue Administration calculated the Decree Law 157 deduction and sent the taxpayer a voucher in the form of an investment coupon. The reasons for not taking advantage of this benefit are probably rooted in the educational level of the country. The literature is not specific in this regard, but there is a fair inference to be made. At the inception of the law, corporations as well as individuals could get the exemption vouchers (10 per cent for individuals, 5 per cent for corporations). Later, the corporate vouchers were eliminated and, in 1972, a variable credit went into effect: 12–24 per cent credit, varying inversely with taxable income [24, p. 9]. At the inception of Decree Law 157, the holding period prevented liquidation of more than 30 per cent after two years, 50 per cent after three years, and 20 per cent after four years. More strictures were applied later and now they remain nonnegotiable for five years, 50 per cent negotiable after six years.

To be pointed out later, rules of this type are applied to repatriation of foreign equity investment in Brazil over varying periods of time, with tax-abatement at the source varying with length of time held.

The Brazilian tax-incentive program for the purchase of equities has not gone unnoticed in the United States. In January of 1976, President Ford presented an as yet unimplemented plan, with similarities to the Decree Law 157 idea, involving a tax deferral of up to $1,500 per year for investment in common stock held for seven years. There would be a limit on income of $40,000 for participation. Investment could be made on a sliding scale for those with incomes up to that amount. Comment has been made that this would help maintain a secondary market for established companies, ignoring the necessity for a primary market for new "venture" shares [27, p. 1]. This action, it is claimed, would give a

one-time boost to the prices of common listed shares, and benefit people already "in the market."

A necessary perspective, needed to differentiate between Brazil's embryonic stock market and the exchanges of the United States, indicates the primary urgency within the Brazilian financial community, to establish a broad and liquid trading medium. The Open Capital Corporation Law pressed for an immediate injection of capital into the economy without a broad base of investors, and without a sustained effect. When the thin primary and secondary markets came to life, the small floats of stock and the tax incentives produced a galloping and plunging market unnerving to the investor, and small in incentive or encouragement to the neophyte (see [23, p. 2] [17, p. 61] [10, p. 3] [18, p. 6]).

One concept concerning the use of the Decree Law 157 funds in a free (?) market was the subject of much discussion within the group of economists directing the distribution of the proceeds. The Minister of Finance in 1966 wanted the tax funds used for companies in financial difficulty. The basic conflict between corporate welfare-statism and development of equity markets originated with this action. The concept of financial difficulty within the Brazilian corporation of the 1960s was the pressure of short-term instruments rather than an inability to produce. The injection of the Decree Law 157 funds as long-term instruments was a logical method to take refinancing pressures off management and allow them to concentrate on production. The effects were mixed because it was difficult to determine the nature of the shortfall for each company involved.

Between 1965 and 1970, monetary transaction volume on the Rio Exchange increased by 1600 per cent. Between 1967 and 1970, Decree Law 157 fund offerings increased by 92 per cent, and public offerings between 1968 (the first year of required registration) and 1970 increased 30 per cent. This indicates the importance of the Decree Law 157 funds, the growth of public offerings by the investment banking community, and a general awakening of investment interest based on a positive attitude on the part of the government toward the debt-asset system [26].

H. *Fiscal Incentive Dynamics and Tax Reform under Decree Law 1338*

Capital market voids existed on a geographic basis as well as within specific sectors of the economy. Decree Law 1338 of July 17, 1974 was a complicated and highly imaginative exercise in capital market formation. This law pointed up the fine-tuning mechanism the government could bring into play to direct the flow of savings to specific areas. It had as its main objectives:

(1) Reordering of priorities to encourage investment in equity and long-term fixed securities as opposed to government bonds and bills.

(2) Decree Law 157 had a built-in regressive tendency favoring the higher-bracket taxpayer. The new law smoothed out the differences, helping the low-bracket payer by changing tax credits to deductions from taxable income. Under Decree Law 157, the incentive was in the form of a tax credit; under Decree Law 1338, the incentive was actual percentage deductions from taxable income. There is a maximum limit on total tax credit, varying inversely with gross income.

TABLE II

FISCAL INCENTIVES APPLICABLE TO MAIN FINANCIAL INSTRUMENTS

(Percentage Investment Deductible from Income Tax Liability)

Financial Instrument	After DL 1338	Before DL 1338 Income Bracket Taxed at:				
		50%	40%	30%	20%	8%
Variable income type:						
New issue, Open Capital Corp.	12	15	12	9	6	2.4
Secondary Open Capital Corp.	6	—	—	—	—	—
Shares from debenture conversion	12	15	12	9	6	2.4
Shares in Northeast or Amazon regions	42	50	40	30	20	8
Shares of tourism companies (hotels)	20	50	40	30	20	8
Mutual fund quotas	9	7.5	6	4.5	3	1.2
Fixed income instruments:						
Government bonds	3	15	12	9	6	2.4
Real estate bills	4	10	8	6	4	1.6
Bills of exchange, CDs and time deposits with ex-post monetary correction	4	—	—	—	—	—
Straight debentures	6	10	8	6	4	1.2
Convertible debentures	6	12.5	10	7.5	5	2
Savings accounts (average balance above $5,000)	2	10	8	6	4	1.2
Savings accounts (average balance below $5,000)	6	10	8	6	4	1.2

Source: Adapted from *Banco Lar*, No. 5 (October 1974), p. 7.

(3) The National Monetary Council could change the crediting structure to rechannel investments in the national interest at short notice.

This complex and innovative structure is considered a milestone in the development of Brazil's capital market and is described in Table II. The range in incentives from 2 per cent to 42 per cent is a graphic illustration of the directional bent of the law. Savings accounts of under $5,000 (approximately) give a 6 per cent deductibility, while those over that amount give only 2 per cent. Investment in the shares of corporations in the Northeast or Amazon regions receive 42 per cent [42, p. 6].

Because savings accounts are traditionally the investment medium of the lower-income groups, the required holding period of two years for tax-deduction eligibility was not implemented. However, for savings accounts over $5,000, the tax deduction dropped from 6 per cent to 2 per cent. Equity investments were also exempted from the two-year rule if the proceeds of the sale were immediately reinvested. This encouraged secondary markets and stock liquidity. While the original investment in terms of money was frozen for two years, the ability to trade was not impeded. Equities were made more attractive than debentures or government bonds by assigning a higher scale of discount of variable instruments of all kinds.

TABLE III

PROGRESSIVE SCHEDULE OF TAX CREDIT MAXIMUM LIMITS UNDER DECREE LAW 1338

Gross Income Brackets (Converted into Dollars, Using $1=7.5 Cruzeiros)	Upper Limit of Tax Credit as a Percentage of Tax Liability
Up to $7,600	60
$7,601-$10,200	55
$10,201-$14,000	50
$14,001-$18,350	45
$18,351-$25,200	40
$25,201-$40,200	35
$40,201 or more	30

Source: Adapted from *Banco Lar*, No. 5 (October 1974), p. 6.

After the difficulties of 1964, with the attendant change in government, treasury paper and treasury bonds were viewed by the Brazilian financial community as of less than "triple A" quality. Consequently, they suffered the below-par, high-yield syndrome. With gradual restoration of confidence, the yield rate dropped and the government reduced the tax discount for government paper to encourage the equity markets.

Time deposits and bank acceptances were granted 4 per cent discounts after two years of immobilization. This effected a significant change in the holding periods for the financial institutions. They were able to deal better as intermediaries within the banking community. In effect, the time deposits became two-year certificates of deposit (CDs) as we know them, allowing the bank a much-desired holding period. This also allowed for an ex-post monetary correction on a more rational basis. The prefixed correction of monetary instruments produced violent money market movements because investors were unsure of rates in a rapid inflationary period and demanded large bonuses, possibly justifiable, but causing erratic and unstable interest rates.

Rounding out the fiscal incentives of Table II, the use of real estate bills in the housing market was brought into line with acceptance paper and time deposits. After 1973, convertible and fixed debentures were given incentive priority above acceptance money, again to render encouragement to the debt-equity market.

Every effort was made (and continues) to refine the system of tax incentives. Coincidentally, as shown in Table III, the regressive nature of the taxation was acknowledged by introducing equalization formulas based on marginal taxation rates to widen the financial horizons of the public [24, p. 11].

I. *The Entry of Foreign Capital into the Trading Markets*

Sporadic attempts had been made prior to 1975 for foreign traders to enter the Brazilian stock market. Restrictions involving taxation of foreign holdings, difficulty in repatriation of funds, and currency exchange difficulties have discouraged investment by non-Brazilian nationals. During the 1969 speculative fever in the Brazilian markets, $8 million in United States money entered the

Bolsas. As investment fever travelled north to the United States, with great speculative interests here, the Brazilian market attracted only $1 million in United States funds [3, p. 9].

No general trend developed to attract outside money because it was felt that the internal incentives were sufficient to generate capital formation. Foreign investment implied further balance of trade distortions, with the eventual removal of sorely needed capital from Brazil. The equity markets, in spite of their rapid growth, were thin, and any sizable influx of funds could produce great distortions.

Direct foreign investment by multinational corporations was regulated by Brazilian law since 1962, with $1 billion entering the country annually. About $6 billion entered annually in the form of loans, but neither the direct investment nor loans involved stock market transactions [25, p. 5].

Decree Law 1401 of May 7, 1975, and Central Bank Resolution 323 of May 8, 1975 were the enabling acts for the entry of foreign capital for debt-equity investment. Decree Law 1401 authorized the formation of investment companies which were to be specifically concerned with the mobilization of foreign resources into the Brazilian capital market. The tax treatment of investments within the scope of the law, and the details regulating repatriation of the funds were the subject of the eight articles of Decree Law 1401. The Central Bank Resolution regulates the actions of the investment companies, spelling out procedures for registration of incoming capital, capitalization of the investment company, and imparting to the new venture a regulatory atmosphere necessary to impart confidence [2, p. 35].

The importance of this pioneer effort in the internationalization of the Brazilian market, aside from the injection of needed funds, lies in the fact that this is the first country with a nonconvertible currency to actively seek foreign investment. Convertible currency (the so-called "hard" currency) is freely traded and exchangeable into any other currency. The dollar in the United States, the West German mark, and the Swiss franc are examples of "hard" currencies. Brazilian cruzeiros at this time are in the category of "soft" currency— the official market rate set by the government and the free market rate elsewhere differ markedly. The official rate of 9.6 cruzeiros to the United States dollar in Brazil contrasts with the 12.5 cruzeiro rate in the nondomestic market, producing an "external devaluation" of 30 per cent [5, p. 41]. It must be assumed that investments in instruments available to foreign nationals will have to be brought and repatriated at official exchange rates. Circular No. 254 details Resolution 323:

> (a) Purchase of Foreign Exchange from the Central Bank of Brazil in Order to Establish a Deposit:
> . . ."Rate-CR$"—fill in the rate of cover by the Central Bank of Brazil at the rate of exchange in effect on the date of the exchange contract. . . .
> (b) Sale of Exchange to the Central Bank of Brazil for Release of Deposit:
> . . ."Rate-CR$"—fill in the rate for exchange cover operations of the Central Bank of Brazil in effect on the date of the exchange contract. . . . [2, p. 56]

This restricts purchases and sales to official exchange rates after tax treatment.

The documents, in translation, detailing the entry of foreign resources are now

generally available [2, pp. 35–56]. The salient features, subject to modification through experience, include:

(1) Foreign funds will enter the Brazilian stock markets in the form of a closed end fund called an Investment Society.

(2) Investment Societies must have authorization of the Brazilian Central Bank.

(3) Investment Societies will be sponsored by Brazilian investment banks or brokerage houses meeting minimum standards of capitalization, experience, research capability and willingness to invest original paid-in capital.

(4) Foreign capital must be invested for a minimum of three years.

(5) The portfolio must be diversified, limited as to investment in any one security, and must at all times be 50 per cent invested in shares or convertible debentures of Open Capital corporations from the Brazilian private sector.

(6) The Investment Society cannot enter real estate transactions, and is prohibited from making loans, trading on margin, rediscounting, selling short, or purchasing shares of other mutual funds.

(7) Dividends and capital gains received by the Investment Society will not be taxable in Brazil.

(8) Dividends are taxed as a percentage of the registered capital base at the time remitted. This will also apply to capital gains. In general, the larger the dividend or capital gain, the more progressive the tax.

(9) Tax advantages are available for long-term holders. [15, p. 1]

It is the government's intent to use the Investment Society funds to bolster the equity markets by the nature of its regulatory intent, much as it did in the case of the Decree Law 157 funds, by making it advantageous to hold funds for the long run in return for favorable tax treatment. Under the law inviting foreign participation, it is important to note that fixed obligations with ex-post monetary correction are not to be included in the portfolios. The repatriation of capital gains is not reckoned on a share-by-share basis, but rather a percentage of the value of the original investment, calculated in the currency of the country of origin. Thus, the taxation varies with the percentage of the original total investment repatriated, with higher taxation for larger gains repatriated earlier than eight years, on a sliding regressive (for earlier withdrawal) scale. If a fund, such as "the Brazil Fund," proposed to be launched by a consortium of British, Scotch, and French investment houses, were to materialize, tax considerations might make the investment attractive. Countries having tax treaties with the United States make it possible for American investors to credit taxes directly against their tax obligations producing interesting tax-avoidance mechanisms.

J. *Attracting Foreign Investment*

The protection necessary to attract the foreign investor must be included in the new "packaging." As yet, an all-encompassing securities code does not exist for Brazilian stocks. The drafting of a new law to modify corporation law of 1940 vintage proposes some basic changes:

(1) Unless retention is justified for expansion, at least 50 per cent of the profits are to be distributed in the form of dividends. (In the United States, in order to be

tax free, closed-end funds must distribute 90 per cent of capital gains income, and the Internal Revenue Service does not allow retention of excess profits.)

(2) Minority shareholders in disagreement with company policy would have shares repurchased.

(3) In mergers, tenders, or acquisitions, small shareholders would receive the same price as majority shareholders.

(4) More complete disclosure to be made; holders of 5 per cent or more of equity could question fiscal council of corporation; fiscal council has an obligation to comment on balance sheets. (In this country, 5 per cent limitation would effectively eliminate questioning by small stockholder, and is probably true for Brazil.)

(5) Obligation of a corporation to include a consolidated balance sheet when 30 per cent or more is invested in a related enterprise.

(6) The creation of a Brazilian Securities Commission along the lines of the USASEC. The rules added by the promulgation of the Capital Markets Act, Law 4728 of July 1965, would be extended by granting authority to act on minority stockholder protection, and the power to control speculation by imposing an ad valorem tax of up to 25 per cent (this last mechanism is a rather strong action—contrast it with the U.S. suspension of trading in erratic or contrived markets). [15, pp. 1–3]

There can be no great rush to participate in the Brazilian market by investors in the United States because of strictures made applicable by SEC regulations. The basic requirement of three years of operative experience for a foreign mutual fund to be approved for sale in the United States would constitute the first reason for delay in entering the United States market [21, p. 5]. The Investment Company Act precludes registration without a finding that the company could be legally regulated within the scope of the act, which for mutual funds in this country tends to be very strict. The general regulatory sentiment is such that foreign companies should be held to the same standards as domestic mutual funds. At the present time, there are seven funds registered in the United States, of which four are Canadian. The "one-financial-world" concept of the OECD (Organization for Economic Cooperation and Development) asks that member nations adopt common standards for mutual funds. This is not likely in the near future.

K. *Conclusions*

The actual mechanisms and the physical housing of the Bolsas within Brazil are adequately and carefully described in publications of the Rio de Janeiro Stock Exchange [22]. The Rio Exchange is responsible for more than half of the trading on all the exchanges, and bears the same relationship to the others as does the New York Exchange to the American, the Pacific, and other smaller exchanges.

The Rio Bolsa is highly automated, having its own computer network, and sponsors ongoing projects dealing with market data information, a clearing and settlement system, back-office service, and a general custody pilot system. An attempt is being made to incorporate into the main computer network a complete historical value system and a balance sheet system. This will enable stock market personnel and customers with a thirst for knowledge to retrieve information from

any terminal supplied by the master system. They have also developed their own indexes and averages to measure the behavior of the trading market, comparable to the U.S. Dow Jones and Standard and Poor's indexes. The basic trading and evaluation mechanisms are similar to those in the United States.

The opening of the Bolsa to foreign investment, closely regulated, can have no immediate effect on the Brazilian economy. Indeed, when viewed as a whole, the debt-equity market to date is still in a formative state. The 1975 deficit in the balance of payments approximates $5 billion. Valiant attempts to curb inflation have been only moderately productive. Brazil would need over $7 billion to balance this year's deficit. Against this background, an infusion of moderately long-term money in the form of equity flow would be highly desirable, but many years will be required before this could materialize.

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