

Strategic Challenges for the Investment Fund Industry

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Regulatory Framework of the Investment Fund Industry

Summary

The system of supervision until 2001, and after 2001

Investment Funds and Investment Companies

The statutory limited legal treatment

Legal Nature of Funds

Registration with the CVM

Main participants and their Responsibility

Is the quotaholder a consumer of financial services?

System of Supervision until 2001

Restrictive Concept of Security

- Law no. 6,385/76 (which created the CVM): Exhaustive list of securities, with the possibility of its extension through a Rule of the National Monetary Council (*Conselho Monetário Nacional*).

Regime of Quotas of public equity funds

- Only the quotas of investment funds in securities (in reality, public equity (stock) funds - *FIA*) were considered securities, and submitted to the regulation and supervision of the CVM.

Regime of Quotas of the other funds

- The quotas of investment funds concentrated in public bonds (*FIF*) were not considered securities, because such bonds were not (and still aren't) considered securities under Brazilian Law.

The role of the Central Bank of Brazil

- The FIFs were supervised by the Central Bank because fund managers not regulated by the CVM were required to organize themselves as financial institutions. These funds represented the vast majority of investment funds in Brazil.

System of Supervision after 2001

Broad concept of security

- Law no. 10,303/01 (amends Law no. 6,385/76): the existence of a public offering of equity or debt becomes the determining factor in the qualification of a bond or contract as a security.

Unified regime

- With the new regime, quotas of publicly offered investment funds, regardless of the predominant assets of the fund, became securities.

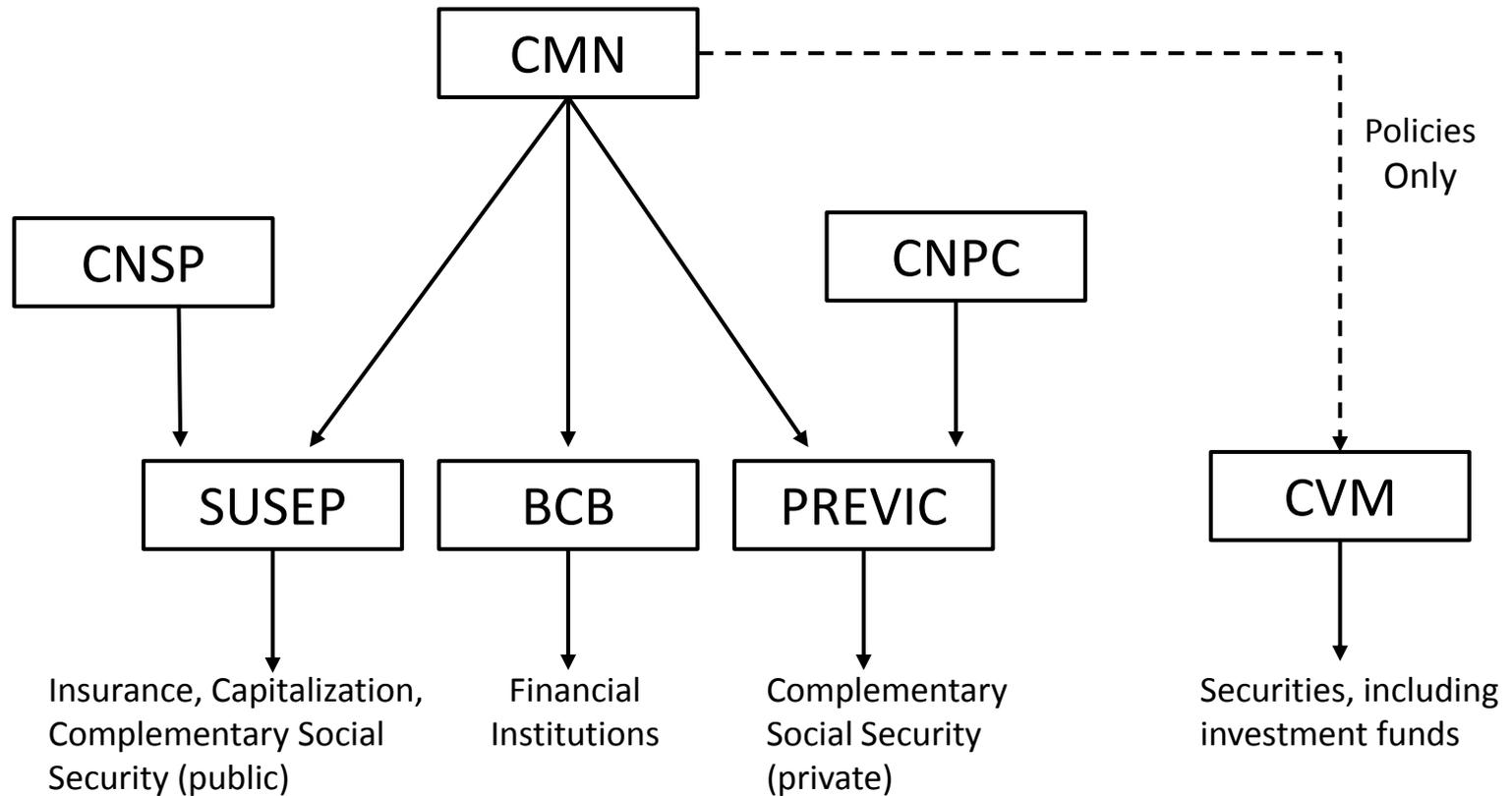
Unified supervision

- As a result of this change, the CVM now had the power to regulate and supervise all investment funds which have publicly offered quotas.

Normative independence

- The same Law no. 10,303/01, which amended Law no. 6,385/76 granted normative independence to the, which became the only entity with the power to issue rules regarding securities.

Regulators of the Brazilian Markets

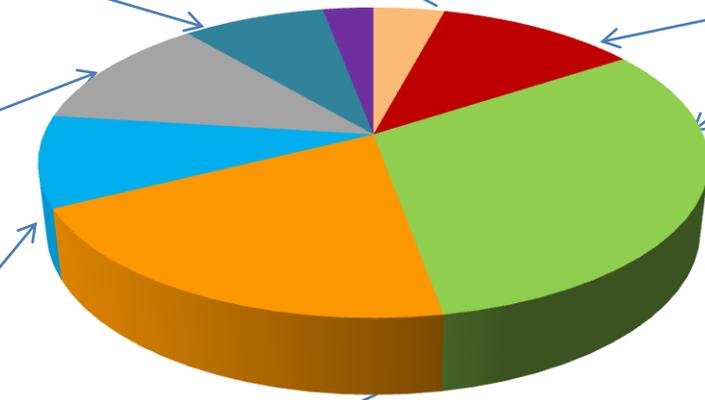


Investment Funds

- **Consolidated Industry**
 - 11.614 on shore investment funds
 - 6.746 Investment funds
 - 4.868 funds of equity funds
 - R\$ 1,97 trillion in net assets
 - 10,8 million investor accounts
 - 93 Administrators affiliated to Anbima
 - 443 Managers affiliated to Anbima

Industry's Snapshot

Distribuição do PL por categoria



Receivables Funds, Private Equity and Real Estate already account for 8,2% of the net assets of the industry

Pension Funds represent 11,9% of the net assets of funds

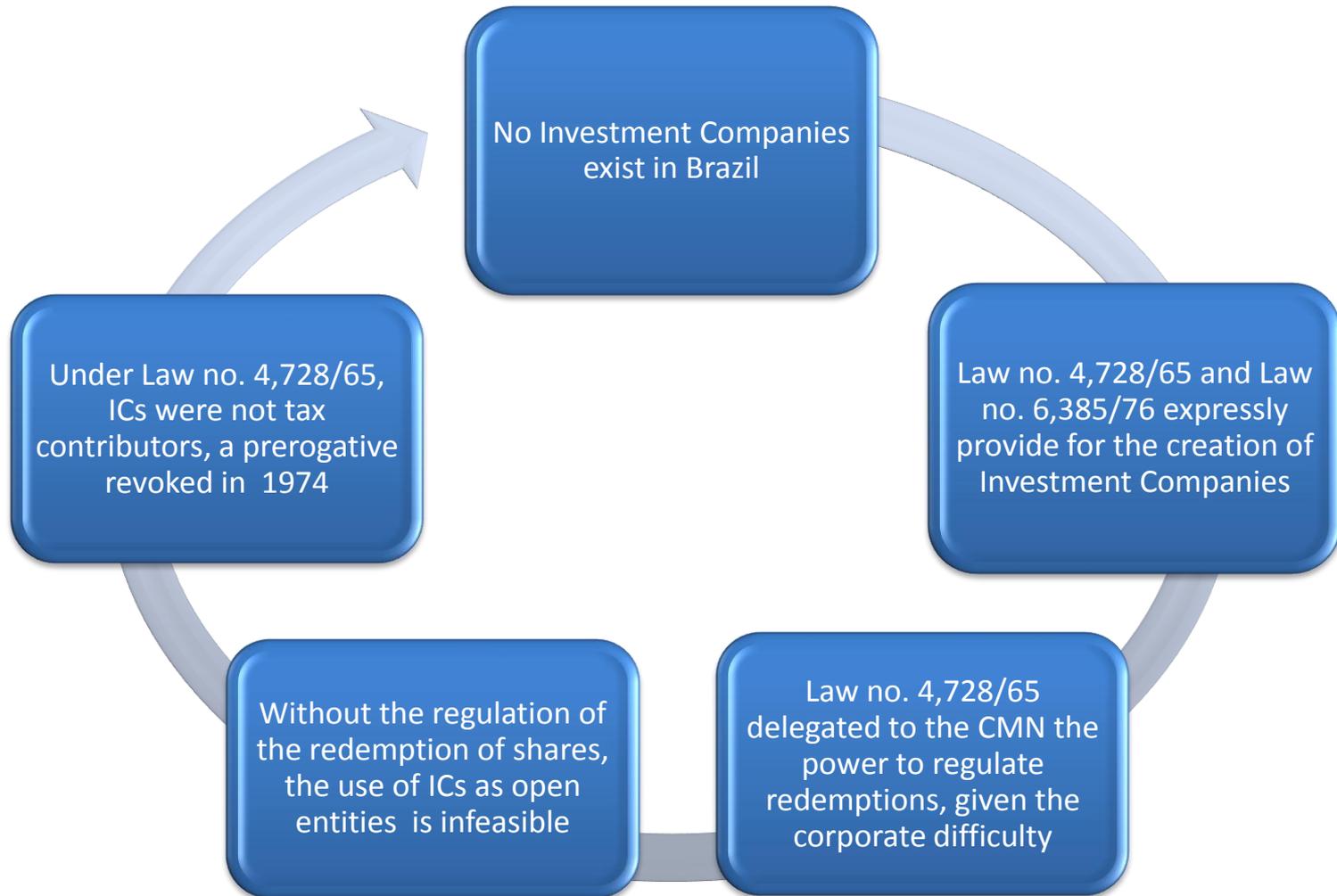
Public Equity Funds (shares) correspond to 9,5% of the net assets of funds

Fixed Income Funds, Money Market Funds and Short Term Funds represent 47,2% of the net assets of funds and their portfolios are predominantly comprised of debts instruments, largely public federal securities

Hedge Funds correspond to 20,3% of the net assets of funds

* FIDC, FIP and FII
** Forex, Foreign Debt, Exclusive Private and Offshore

Investment Companies



Reduced Legal Treatment

- Law no. 4,728/65
 - Focus in Investment Companies (including an incentive of conversion of then existing investment funds into companies), designed to be both the vehicle and manager of collective investments
 - Express reference to the collective nature (condominiums) of investment funds
 - Mandatory annual meeting of quotaholders and independent audit
- Law no. 6,385/76
 - Authority of the CVM to regulate (in light of fund shares being securities) and supervise
 - Authority of the CVM to authorize the exercise of the activity of asset management of securities
 - Authority of the CVM to sanction asset managers

Legal Nature of Funds

Special condominiums (*special* because regulated by the CVM and not merely by the Civil Code)

- Legal nature arising from Law no. 4,728/65
- Doctrinal controversy:
 - To some, corporate nature
 - To others, institutional nature (notably in retail funds)
 - The matter of Exclusive Funds (condominiums of a sole proprietor?)

Registration with the CVM: attraction to the regulated environment

- In theory, according to Brazilian Law, it is possible to constitute an investment fund and not register it with the CVM.
 - All that is needed is to refrain from a public offering of the fund
- However, several factors have led virtually all investment funds (public and private, private equity and even, as mentioned, those with a sole quotaholder) to be registered in the CVM
- These factors are:
 - Registration is a requisite for applying the adequate accounting treatment
 - Frequently, for safety, a decision is made to voluntarily or contractually submit the fund to the form and supervision of the CVM
 - Regulatory requirement incidental to investors (other investment funds, pension funds, insurers, banks, etc...)

The main participants, according to the CVM's regulations

Administrator

- Is the central figure
- Can retain all of the activities to which he is authorized, except auditor

Manager

- Function that may be delegated by the Administrator to third-parties authorized to manage portfolios
- Personal administrative responsibility

Custodian

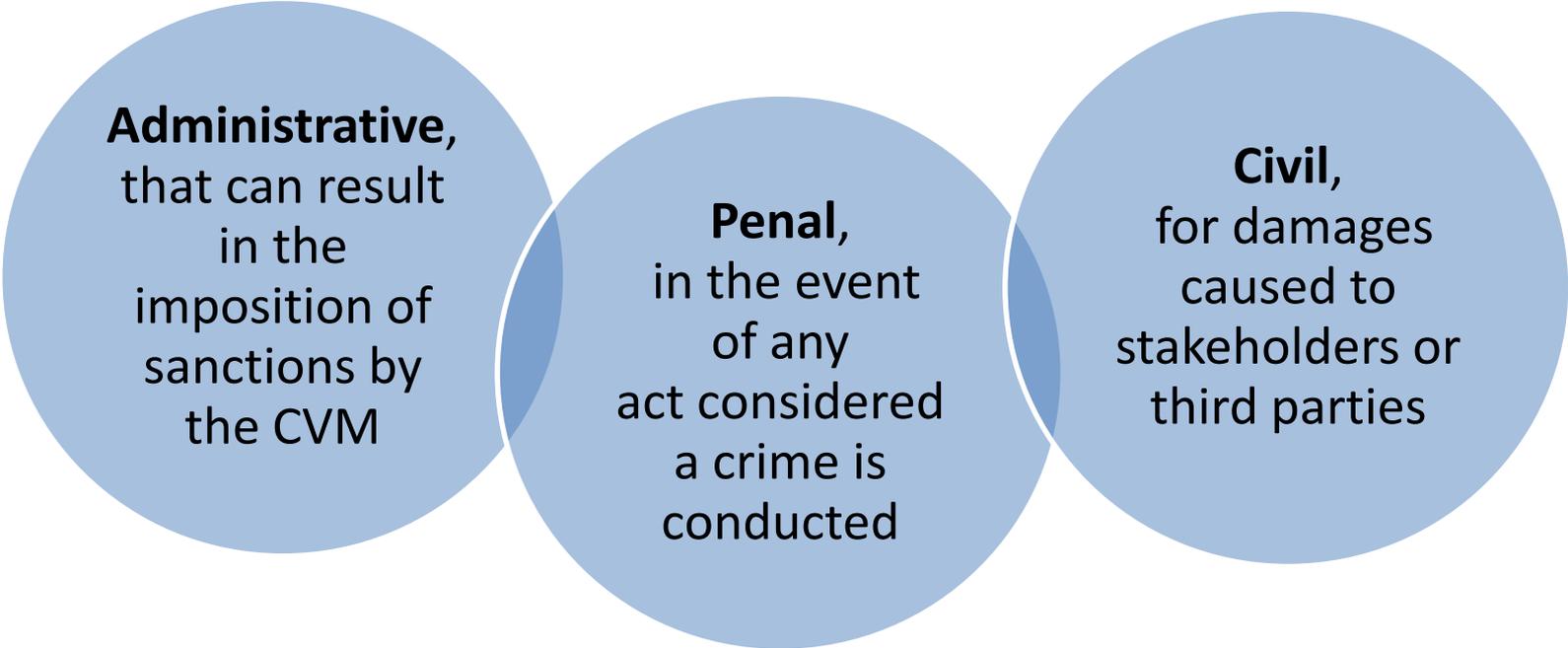
- CVM authorization required for the exercise of the activity
- Can be indicated in the fund's By-laws or act by the Administrator's delegation

Auditor

- Mandatory independent function
- CVM authorization required for the exercise of the activity

Responsibility of the Agents

All service providers whose performance is imposed by CVM as a condition for the operation of an investment fund are subject to three potential types of responsibility

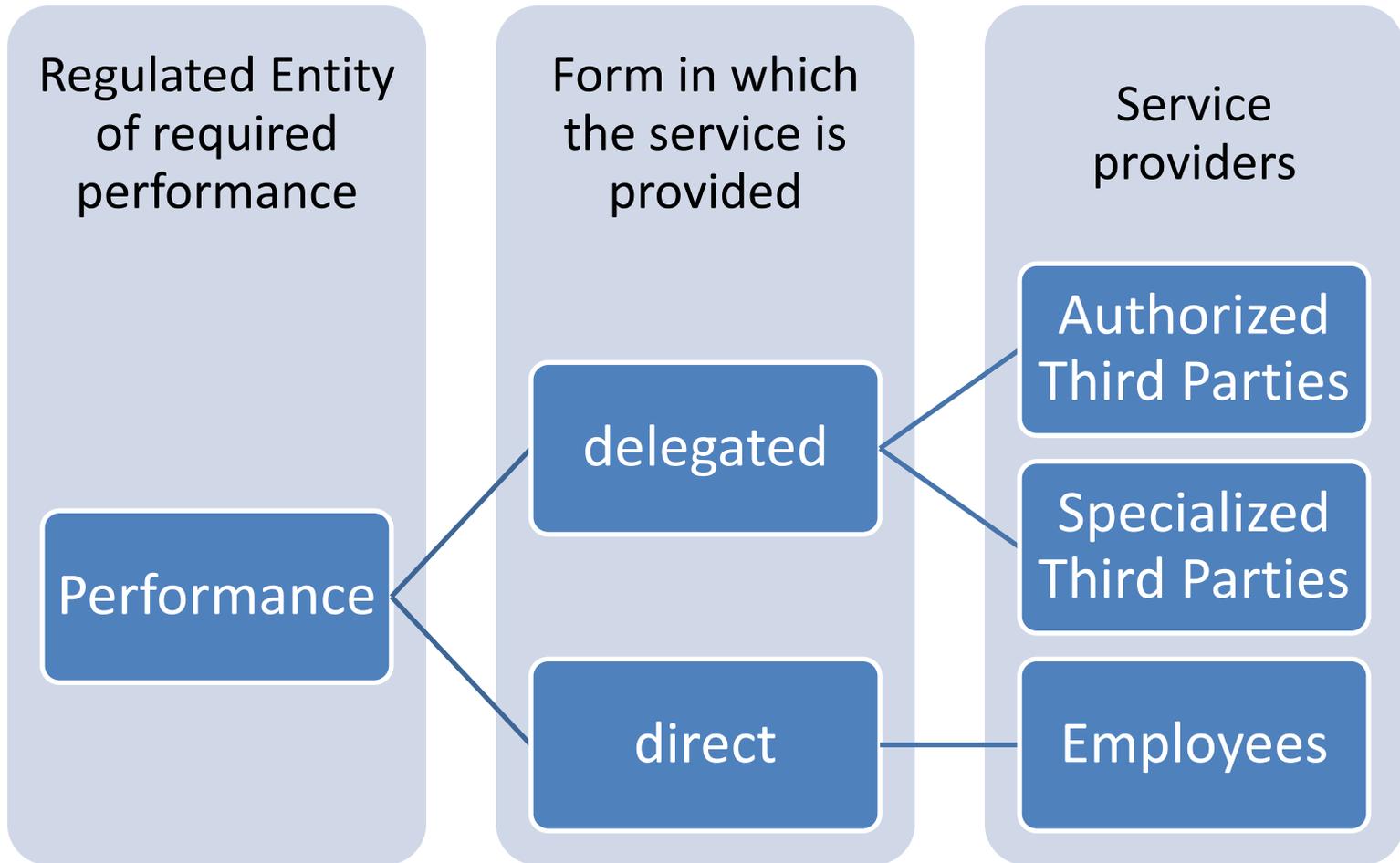


Administrative,
that can result
in the
imposition of
sanctions by
the CVM

Penal,
in the event
of any
act considered
a crime is
conducted

Civil,
for damages
caused to
stakeholders or
third parties

Delegation of Functions



Administrative Responsibility

- Administrative responsibility (as is the case in penal responsibility) always and necessarily follow personal actions. That is, there is no joint administrative liability, or resulting from the actions of a third party.
 - This occurs even in the event of delegating regulatory functions to third parties.
 - When delegating to authorized third parties, the CVM will sanction the third parties for the practice of actions or personal omissions, and not the regulated entity whom delegated the powers to them.
 - When delegating to specialized third parties, which are not authorized by the CVM to perform the service, the responsibility lies with the regulated entity which delegates the service or activity.

The so-called Outsourcing

- Delegation to non-authorized third parties, also called outsourcing:
 - Choice to perform the activity through contracted third parties, instead of employees
 - There is no actual delegation, but the fulfillment of obligations through contracted, and not personal resources
 - A licit option, unless in the case of a false declaration when obtaining authorization from the CVM to exercise his function, regarding the size of his operational framework
 - Allows for the contracting of more specialized third parties to carry out certain functions, which may be beneficial to the quality of the services.
 - Because the agent retains full responsibility, the possible incentives in cost should not be enough to motivate the authorized regulated entity to delegate the regulated function to unprepared third parties.

Civil Responsibility

- In certain cases, CVM regulations require that the regulated entity, whilst delegating activities to third parties, remain jointly obligate through contract.
 - Such cases are the management of portfolios, treasury activities, control and processing of securities, and the bookkeeping of the redemption of quotas (Article 57, § 2º, of CVM Rule 409).
 - In these cases, the regulated entity is *civilly* liable, in solidarity with the delegated third parties, despite them being authorized by the CVM, in the event of an illicit practice.
 - The opposite is untrue. That is: the third party does not respond for damages caused by the regulated entity which delegated his powers.

Is the quotaholder a consumer?

- In terms of the civil liability of the regulated entities, there is a substantial difference in treating a quotaholder of an investment fund as a consumer of financial services, under the protection of the Brazilian Consumer Defense Code If a consumer relation is considered:
 - Civil responsibility will not depend on the proof or evidence of guilt, all that is needed is proof of damages and the nexus of cause with the act or omission by the regulated entity (objective responsibility)
 - It can be sustained that there will be a joint civil liability of all of the service providers (what does not seem to be the case)
- However, there will not be, under any circumstances, room to eliminate the inherent risks of the investment.