LW REPORT

L E H M A N N, W A R D E
A d v o g a d o s

01 | April 2013

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INVESTING WITH BRAZILIAN PENSION FUNDS

The rules of the game

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National Monetary Council (CMN) Resolution No. 3792 of September 24, 2009 ("Resolution")[1] lays down the general guidelines and the main restrictions relating to investment of funds from plans managed by closed-end private pension entities (entidades fechadas de previdência complementar - EFPC), the so-called pension funds.[2]

Brazil has over 250 pension funds, which jointly account for more than R$ 614 billion in investments.[3] This humongous amount of funds comes to a large extent from savings from workers who participate in the entity and benefit from its investments. For this reason, pension funds' market activities are highly regulated. Such fact, however, has not prevented them from becoming the greatest booster of investments essential to the country. Achievement of their dual purpose (to benefit workers and to invest in the market) has become increasingly difficult due to lower returns on fixed-income investments. This scenario will probably cause pension funds to turn to private equity to maximize their results, either individually or by adopting strategies of co-investment with specialized funds.

This extremely important issue will be addressed by the LW Report in the series "Investing with Brazilian Pension Funds." This edition, which deals with the major rules applying to EFPC investments, will explain systematically the limits and bans imposed by the Resolution. For reference purposes, Annex I contains a full chart with the main information on regulation of the allocation of EFPC funds.

Identifying, assessing and controlling risks

EFPCs must secure the economic balance of each plan they manage. All investment opportunities must be carefully scrutinized with a view to identifying, assessing and controlling risks.

Custody and clearing

Investments must be preceded by engagement of custody and clearing services to secure the flow of payments and receivables relating to EFPC investments, coupled with an analysis and safekeeping of the invested securities.

Investment Policy

EFPCs must first establish their investment policy, which must meet certain minimum requirements prescribed by law (such as allocation of funds, the limits per investment segment, and the limits per type of investment). They must also observe the general rules and principles set out in the Resolution (as well as the specific rules stipulated in its regulations).

The investment policy limits imposed by the Resolution are divided into two large groups: (A) bans on certain types of investment; and (B) limits per type of investment.

Investment segment	Examples of investment	Examples of limits
Fixed income	Federal, state and municipal government bonds	Up to 100% in federal government bonds and up to 80% in other types of investment in this segment
Variable income	Shares issued by publicly-held companies and the corresponding subscription warrants, receipts and certificates of deposit, and securities issued by special purpose entities (SPE)	Up to 70% in shares issued by publicly-held companies listed on the Novo Mercado segment of BM&FBovespa, 50% in shares listed on the Bovespa Mais segment of BM&FBovespa, 45% in shares listed on the Nível 1 segment of BM&FBovespa, and 35% in shares of other publicly-held companies
Structured investments	Shares in equity investment funds, shares in funds for investment in shares of investment funds (fund of funds), and shares in venture capital funds	Up to 20%, of which up to 10% in shares of real estate investment funds or in shares of investment funds and shares of a fund investing in hedge funds
Investments abroad	Assets issued abroad belonging to portfolios organized in Brazil, subject to the Brazilian Securities Commission (CVM) regulations, shares of investment funds and shares of funds investing in foreign debt funds	Up to 10%
Real properties	Real estate developments and properties for rent and income	Up to 8%
Transactions with participants	Loans extended with funds from the pension fund to its active and inactive participants, and real estate credit extended with funds from the pension fund to its active and inactive participants	Up to 15%

Table 1 - Segments, investiments e limits

A) Bans on certain types of investment

The Resolution bans the following activities: (i) to carry out transactions between plans managed by the same pension fund, except in cases of transfer of funds, provided that the conditions established by the regulatory bodies are observed; (ii) to operate as a financial institution; (iii) to carry out credit transactions with its sponsors; (iv) to tender sureties, aval guarantees, acceptances or to act as co-obligor in any way; (v) to act as developer, directly, indirectly or through a real estate investment fund; (vi) to acquire or keep land parcels, except those intended for the development of real estate undertakings or construction of real properties for rent, income or one's own use, provided that such purpose is included in the pension plan's investment policy; and (vi) to invest in assets or types of investment not contemplated by the Resolution.

The last ban has instituted an important general rule on EFPC investment matters: any investment segment not expressly permitted by law and by the regulatory bodies is prohibited to the EFPCs.

B) Limits

B.1. Investment segments

The Resolution establishes six different investment segments for EFPC funds. Beside are some examples.

B.2. Other limits

In addition to the limits per investment segment, there are also other limits relating to: (i) allocation per issuer; (ii) concentration per issuer; (iii) concentration per investment; (iv) derivatives transactions; and (v) characteristics of investment funds.

(i) Allocation per issuer

National Treasury securities are the only securities in which pension plans may invest 100% of their funds. No more than 50% of pension plan funds may be invested in securities issued by financial institutions. Investments in securities issued by the state or municipal treasuries or investment funds are capped at 10%.

(ii) Concentration per issuer

Considering the total funds managed by an EFPC, no more than 25% may be invested in, among others: (a) the total capital stock of one same publicly-held company or of one same SPE; (b) the voting capital of one same publicly-held company; (c) the net equity of one same financial institution authorized to operate by the Central Bank of Brazil (Bacen); or (d) an investment fund classified in the segment of structured investments or which has its asset portfolio classified in the segment of investments abroad.

(iii) Concentration per investment

Out of the total funds managed by an EFPC, no more than 25% may be invested in, among others: (a) one same series of securities; (b) one same class or series of shares in receivables investment funds; or (c) one same real estate development.

(iv) Derivatives transactions

The following conditions must be present, cumulatively, for an EFPC to be allowed to carry out derivatives transactions: (a) prior assessment of the risks involved; (b) existence of internal controls appropriate to its transactions; (c) registration of the transaction or trade on stock and commodities exchanges; (d) settlement and clearance providers and chambers acting as central counterparties to secure the transaction, (e) margin deposit limited to 15% of the position in federal government bonds, securities issued by a financial institution authorized to operate by Bacen, and Bovespa Index stocks on the portfolio of each plan or investment fund; and (f) total amount of the option premiums paid limited to 5% of the position in federal government bonds, securities issued by a financial institution authorized to operate by Bacen, and Bovespa Index stocks on the portfolio of each investment fund or plan.

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(v) Investment in funds

The funds in which an EFPC holds an interest must have, among others, the following characteristics: (a) they must be registered with CVM; (b) they must observe the types of investment, requirements and conditions established in the Resolution; and (c) investments must be consolidated with the positions of the pension fund's own portfolios and managed portfolios in determining the limits established by the Resolution.

C) Conclusion

Pension funds play an important role both as a welfare provider and as a market investor, all of which justifies the strict regulation imposed on them. In this edition of LW Report, the main limits and bans on allocation of managed funds under CMN Resolution 3792 of 2009 have been analyzed. These provisions, notwithstanding, do not prevent pension plan regulations of stipulating other limits, bans and, above all, general investment strategies. The next edition of the series "Investing with Brazilian Pension Funds" will address this specific regulation and examine the cases of Previ, Petros and Funcef, the three largest Brazilian pension funds.

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Advogados

References

[1] CMN Resolution 3792 repealed CMN Resolution No. 3456 of June 1, 2007, CMN Resolution No. 3558 of March 27, 2008, and CMN Resolution No. 3652 of December 17, 2008.

[2] Pension funds are monitored by the National Private Pension Oversight Office (PREVIC), a body reporting to the Social Security Ministry that superseded the Private Pension Office (SPC).

[3] According to information from ABRAPP, the Brazilian Closed-end Private Pension Entities Association, June 2012.