

A PRELIMINARY SURVEY  
OF THE BRAZILIAN STOCK MARKETS

By: Norman S. Poser and Allan R. Roth

December 1965

## TABLE OF CONTENTS

	<u>Page No.</u>
1. INTRODUCTION .....	1
2. BACKGROUND .....	6
3. THE SECURITIES INDUSTRY .....	10
(a) Stock Exchange Brokers .....	10
(b) Commission Rate .....	12
(c) Credit, Finance, and Investment Companies .....	14
(d) Recommendations .....	17
4. DISTRIBUTIONS OF SECURITIES .....	19
(a) Underwriting of New Issues .....	20
(b) Tax Provisions .....	22
(c) Problems of Disclosure .....	26
(d) Shareholder Relations .....	31
(e) Recommendations .....	33
5. THE TRADING MARKET .....	35
(a) Trading Data .....	35
(b) Influences on Stock Prices .....	40
(c) The System of Trading .....	42
(d) A Continuous Auction Market -- the SNI Plan .....	47
(e) The Question of an Over-the-Counter Market .....	52
(f) Recommendations .....	55
6. THE REGULATORY NEEDS .....	56
(a) The Self-Regulatory Capabilities .....	56
(b) Regulation by the Government .....	59
(c) The Role of AID .....	62
(d) Recommendations.....	63
7. CONCLUSION .....	64

A PRELIMINARY SURVEY OF THE  
BRAZILIAN STOCK MARKETS

By Norman S. Poser<sup>1/</sup> and Allan R. Roth<sup>2/</sup>

1. Introduction

In August 1965, the Central Bank of Brazil requested the Agency for International Development to provide technical assistance in connection with the operation and regulation of the country's capital markets. Specifically, the Central Bank asked for two specialists, one from the Securities and Exchange Commission and one from a U.S. stock exchange, to spend two to three months in Brazil. Owing to the difficulty of making two qualified persons available for a period of this length, it was agreed that a preliminary visit of approximately two weeks would be made, with the possibility of providing future assistance at a later date. This report is written as a result of the preliminary visit, which took place from September 27 to October 13, 1965.

While we have naturally leaned heavily on our experience and

- 
- <sup>1/</sup> Assistant Director of the Division of Trading and Markets of the Securities and Exchange Commission; former staff attorney with the Special Study of Securities Markets of the S.E.C.; consultant to AID on Indian stock market problems.
- <sup>2/</sup> Assistant Director of the Legal and Government Affairs Department of the American Stock Exchange; former staff attorney with the Office of General Counsel of the S.E.C.; worked on Israeli stock market regulatory problems.

observation of U.S. markets and regulatory techniques in evaluating Brazilian problems and possible solutions, we have tried to avoid the pitfall of assuming that anything that works in our own country will work equally well in Brazil. Differences in the size and the state of development of the capital markets of the two countries may call for a different approach to problems. Similarly, none of the recommendations made in this report should be taken to constitute any implied comment as to what is desirable in the context of the U.S. The views expressed in this report are ours only and are not necessarily the views of the Securities and Exchange Commission or the American Stock Exchange.

It would be foolish to try to reach any hard-and-fast conclusions about the Brazilian markets on the basis of a visit of just over two weeks. The conclusions and recommendations made in this report are therefore of a tentative nature and may need to be modified on the basis of further experience. Furthermore, the report does not attempt to describe the markets in great detail or to discuss every problem. It is, in general, designed rather to deal with basic institutional and regulatory problems and to suggest certain directions in which the Brazilian authorities and the securities industry might move. It also contains suggestions as to what further U.S. assistance might be appropriate. Finally, the report does not discuss the underlying economic considerations but assumes the need of Brazil for vigorous capital markets to encourage and facilitate the flow of capital into the country's economy.

The authors visited the Rio de Janeiro and Sao Paulo Stock Exchanges, and they also had discussions with a considerable number of persons, including government officials, members of stock exchanges and other financial institutions, and officers of publicly held companies.

Among the persons interviewed were:

Central Bank: Denio Nogueiro, president; Luiz Biolchini, vice-president; Sergio Ribeiro, director of the Government debt department; Murilo Gomes Bevilaqua, director of the capital markets department; Ronaldo de Frota Nogueira; Julio Cesar Belisario Vianna.

National Development Bank (BNDE): Jose Garrido Torres, president; Carlos Santos.

Rio de Janeiro Stock Exchange: Ney Souza Ribeiro de Carvalho, president; Henrique Guedes de Mello, Marcello Leite Barbosa, Celio Felajo, members.

Sao Paulo Stock Exchange: Ernesto Barbosa Tomanick, president; Luiz de Souza Barros, Hans Jorge Muller Carioba, members.

Investment, credit, and finance companies: Marcus de Albuquerque e Mello and Jorge Paulo LeMann, of Invesco; Roberto Paulo Cezar de Andrade and Pedro Leitao de Cunha, of Brascan; Julio Cesar Lutterbach and Paulo Nascimento Araujo, of Ipiranga; Eduardo Bastos and Raymond Demolein, of Bastos & Demolein; Herbert Cohn; Jose Roberto de Castro Oliveira, of Independencia; George Shaw and Jean Soublin, of Deltec; Ary Waddington;

Pedro Paulo Leite de Barros and Lucas Nogueira Garcez, of Finasa.

Mutual fund: Hans J. W. Horch, W. R. T. Muir, Antoine-Henry Forrat, of Crescinco.

Publicly held companies: Antonio Ribeiro da Silva and R. L. Whimpenny, of Cia. de Cigarros Souza Cruz; Silvano Santos Cardoso, Henrique de Botton, and Helio Beltrao, of Mesbla.

Investment Service: John O. Schroy, Frank J. de Luca, and Geoffrey A. Langlands, of Servico Nacional de Investimentos (SNI)..

Attorney: Jose Luiz Bulhoes Pedreira.

The authors wish to thank each of these persons for their helpfulness and candor. They especially wish to express their gratitude to Ronaldo Nogueira of the Central Bank, who acted as guide, teacher, interpreter, and friend throughout the visit. They also wish to thank Ingrid Nelson and Fred Siesel of the staff of the Securities and Exchange Commission for their assistance in the preparation of this report.

The report is divided into seven parts. After the introduction, Part 2 briefly summarizes the Capital Markets Law of 1965 and discusses a few underlying matters that must be taken into account in trying to understand the Brazilian capital markets. Part 3 discusses the professionals who make up the Brazilian securities industry and matters concerning their qualifications, compensation, and business. Part 4 discusses the distribution of shares, the tax provisions by which the Government is seeking to encourage companies to distribute their shares to the public, stockholders' rights, and questions of corporate disclosure. Part 5 deals with the trading markets and methods of trading. Part 6 deals with

the capabilities of the Brazilian securities industry for self-regulation, the organization of the Central Bank as a regulatory agency, and the question of further technical assistance. Finally, Part 7 summarizes the authors' conclusions. Recommendations relating to Parts 3 to 6 appear at the end of each of these sections.

2. Background

In July 1965, the Government of Brazil adopted a Capital Markets Law, which promises to have important effects on the country's financial institutions and economy. The law vests broad powers in the Government to regulate companies seeking financing from the public, individuals and firms participating in the capital markets, and stock exchanges. The law leaves the development of standards and administrative procedures under which these powers are to be exercised to rules and regulations to be adopted by the National Monetary Council and enforced by the Central Bank.

The Capital Markets Law also contains a number of important provisions designed to encourage and provide a favorable climate for private investment in corporate securities. The law authorizes the issuance by private companies of bonds, the prices of which are periodically adjusted on the basis of a Government price index in order to neutralize the effects of inflation,<sup>1/</sup> the use of endorsable shares and bonds, the issuance of convertible debentures, and the establishment of private investment banks and investment companies (mutual funds previously could not assume corporate form). The new law also contains provisions that give important income tax advantages to owners of shares of publicly held companies, as compared with holders of other forms of securities.

Almost every person in Brazil with whom we spoke regarded the country's stock markets as being at a "take-off" point. This attitude is

---

<sup>1/</sup> The Government already issues such "monetary correction" bonds.

due partly to the actual provisions of the Capital Markets Law and the implications as to future government policy which it contains. For example, the law ends, within a year after its enactment, the monopoly held by stock exchange members on foreign currency transactions, from which they have heretofore derived a major portion of their incomes. As a result, these persons are now looking to the sale of securities to make up for expected losses in income. There appears to be a general belief that the Government has recognized that the stock markets have an important role to play in marshalling the savings of the public for purposes of economic development.

There is also a widely held belief that economic conditions in Brazil will increasingly favor the "share business." As one experienced investment man explained it, that part of the Brazilian public with savings to invest has never had the habit of investing in securities. Real estate and foreign currency have been more popular as media of investment. Similarly, industrial companies have traditionally been held closely by families or other small groups and have had little interest in selling shares to the public, especially if other forms of financing have been available. During the rapid development of the Brazilian economy in the 1950's these attitudes began to change, but just at that time the Brazilian inflation began. With prices increasing annually by as much as 100 percent, the public turned to short-term exchange bills, which could be purchased at discounts equivalent to an annual yield of 40-50 percent.<sup>1/</sup> Since exchange bills were usually in

---

<sup>1/</sup> Exchange bills are commercial paper issued by companies, usually for periods of between 3 and 18 months. During the past few years they have been a popular medium of investment by the public. See Section 3.

bearer form, this income was not as a practical matter subject to income taxation. Now that the inflation has been at least partially checked and income derived from exchange bills is to be taxed,<sup>1/</sup> the public, having by now become accustomed to investment in short-term securities, may turn its attention to corporate stocks. Furthermore, it is expected that many corporations, induced by the "carrot" of favorable tax treatment and the "stick" of tight credit, will begin to see the practical advantages of selling their shares to the public.

Finally, the question of the confidence of Brazilian investors in the markets deserves a few words. This is an intangible subject that should be approached with caution by someone who has spent only 2 1/2 weeks in the country. Nevertheless, a few things can be said. We were told by persons who appeared to be knowledgeable that shares of several nonexistent companies are today being sold to the public, that stock prices can be manipulated with relative ease, and that trading by corporate insiders and investment persons on the basis of information unavailable to the public is not uncommon. Furthermore, we heard that securities salesmen have been shot at when they ventured for a second time into certain rural districts, and that the general opinion of the ethical and professional

---

<sup>1/</sup> Effective January 1, 1967, purchasers of exchange bills will be required to identify themselves and pay income tax at ordinary rates.

level of stock exchange members is not high. As a result, many potential investors are probably reluctant to commit their savings to the capital markets.

Just as this report recommends that a number of measures be considered for the purpose of strengthening and enlarging the capital markets, it also recognizes that to adopt these measures without having adequate regulatory controls would be to invite disaster and an ultimate lessening of public confidence. The enactment of the Capital Markets Law appears to have already increased public confidence in the markets, since it is taken as an indication that the Government intends to regulate these markets. So long as this regulation is reasonable in its scope and administration, in view of the undeveloped state of the markets and the securities industry, and the need to encourage private initiative and risktaking, its effects should be beneficial.

### 3. The Securities Industry

The Brazilian securities industry may be divided into two major segments. First, there are 98 stock exchange brokers, of whom 48 are members of the Rio de Janeiro Stock Exchange and 50 of the Sao Paulo Stock Exchange.<sup>1/</sup> Secondly, there are a number of credit, finance, and investment companies, which engage in a certain amount of underwriting, portfolio management, and other securities activities. In addition, there are several mutual funds (only one of which, however, is of substantial size), at least one investment service, and several investment advisers.

#### (a) Stock Exchange Brokers

Until the enactment of the Capital Markets Law exchange members enjoyed a protected position in the securities industry. Under a law of the late 19th century that was modeled on the laws governing the Paris bourse, the stock exchanges were allowed to fix their membership and were given a virtual monopoly over transactions in securities and foreign currency. Brokers were required to conduct their businesses as sole proprietors, although they were allowed to hire two substitutes who could execute transactions for them on the floor of the exchange. They were required to be at least 21 years of age, Brazilian citizens, and of good character.

---

<sup>1/</sup> There is a stock exchange in each of the 20 Brazilian states (two in the State of Sao Paulo), but we understand that there is an appreciable amount of trading only on the Rio and Sao Paulo exchanges.

They were not permitted to trade for their own account but were required to act solely as brokers for customers. Furthermore, they were not permitted to be directors or advisors of companies whose shares were traded on the exchange. To ensure their financial responsibility, they were required to place a deposit with the exchange, which is currently fixed at Cr. \$20 million (approximately \$11,000).

During the years since its inception about 70 years ago, this system has developed certain defects. Membership in the exchange came to be handed down from father to son, and many of those who inherited membership had neither the qualifications nor the inclination to conduct a securities business. They retained their membership because it constituted a valuable right; they sent substitutes to do the work and limited their own role to the receipt of commissions. Other members, ignoring the spirit if not the letter of exchange regulations which required members to limit their activities to brokerage, formed companies and went into a variety of businesses, including the acceptance and distribution of exchange bills and trading in commodities. A few of the more enterprising exchange members have built up successful businesses, employing as many as 80 persons, but most of the income of these members is derived from brokerage on exchange bill and foreign currency transactions, rather than from commissions on transactions in corporate shares.

The new Capital Markets Law gives the Government the authority to set the conditions of membership and actually to pass on particular

applications for membership. It also requires that members (except existing members) be organized as corporations and that the managers of these corporations own at least half of the voting stock. In addition, the law directs the National Monetary Council to set minimum capital requirements for exchange members. These provisions appear to give the Government all the power that it needs to effect the greatly needed reforms in the membership of the two major stock exchanges.

(b) Commission Rate

The commission rate on exchange transactions is fixed at 1/2 percent of the price of the shares bought or sold. It was the practically unanimously held opinion of the persons to whom we spoke that this rate is too low to allow exchange members to provide essential services to investors and still earn a profit. To make matters worse, many banks, mutual funds, and other investors with economic power require their brokers to give them a rebate of half of the commission. Thus, Brazilian brokers earn a commission of between 1/4 and 1/2 percent, as compared to a rate of approximately 1 percent that is paid to exchange members in the U. S.

The low commission rate has two important effects. First, it discourages exchange members from selling stocks to their customers and leads them instead to channel their customers' savings into such other investment media as exchange bills, upon which the commission rate is higher. This makes it more difficult for companies

to distribute their shares to the public.

Secondly, the low commission rate makes it economically unfeasible for most exchange members to give their customers adequate services. Conducting a business in stocks involves significantly higher costs than acting as a broker in foreign currency or exchange bills. Among the expenses of a stock brokerage business are a "back office" staff to keep customer records and handle transfers and deliveries of securities, and a research staff to look at companies whose securities are to be recommended to customers.

Few exchange members give their customers adequate services. Delivery of securities, which is required to take place within 48 hours after the transaction, often takes weeks or months. Few exchange members have research departments of any kind, and these generally consist of one or two persons who combine their research activities with other duties, such as assisting their employers on the exchange floor or selling securities to customers over the telephone. Some of the larger exchange members have no research staff at all, although they actively solicit sales of securities. It is therefore difficult to understand the basis for the recommendations that they make. <sup>1/</sup> It seems likely that there is

---

<sup>1/</sup> In fairness to these exchange members, it must be recognized that, owing to the relative unavailability of corporate information, there are strict limits to what a research staff could accomplish.

a close connection between the inadequacy of the services that brokers provide and the low rate of commissions.

(c) Credit, Finance, and Investment Companies

During the past few years there has been a proliferation of credit, finance, and investment companies in Brazil. There are approximately 300 such companies at the present time, only about a dozen of which are investment companies in the sense that they engage in transactions in corporate stocks. The principal purpose and source of income of most of these companies is the acceptance or distribution of exchange bills. Some of them have a large number of salesmen and conduct their business in storefront sales offices located in the principal cities of Brazil. A few also act as underwriters, handle portfolios of customers, manage mutual funds, or do business in the "telephone market" - over-the-counter transactions in stocks that are traded on an exchange.<sup>1/</sup> Some of these firms handle their customers' transactions in stocks through a connection with a stock exchange member. For example, two officers of one investment company have become substitutes of an inactive stock exchange member, and they pay him 20 percent of all commissions received in return for the right to trade in his name. In other cases, stock exchange members have formed investment companies in which they have an interest.

---

<sup>1/</sup> See Section 5.

It was our impression that the credit, finance, and investment companies may well be the most promising source of expertise and enterprise for the capital markets in the years to come. This observation is not limited to companies which are already active in the securities business. A number of companies which have principally been acting as acceptors of exchange bills are now interested in reorganizing themselves as private investment banks, which are permitted under the Capital Markets Law. Perhaps the most important of these is Finasa, a Sao Paulo-based company that is owned by 24 Brazilian commercial banks. Finasa, which was a pioneer in the acceptance business, is now interested in setting itself up to provide long-term financing to Brazilian companies. To augment its own capital, it hopes to obtain loans from the International Finance Corporation, Inter-American Development Bank, and other international organizations, and possibly also to raise money through the sale of its own securities. Under Article 29 of the new statute, companies such as Finasa will be under the regulatory control of the Central Bank in several respects, including minimum capital requirements; maximum interest rates; requirements of due diligence in the analysis of the profitability, solvency, and liquidity of borrowers; diversification of risks; administration of funds held in "condominium"; conditions for the granting of guarantees in Brazilian or foreign currency; and types of operations permitted.

Other credit and finance companies also are considering going into the "share business," but by and large they are waiting to see what regulations the Government adopts under the new statute. In this connection, it should be noted that the Capital Markets Law seems to contemplate the existence of a number of different kinds of organizations in the securities markets. These include brokerage companies, financial institutions, exchange brokers (individuals), private investment banks, investment companies, and investment funds. In order to facilitate the administration of the statute and to minimize the regulatory burden on the firms, it would probably be advisable to establish as few categories as possible when rules are adopted and to make regulation depend on the actual functions performed rather than the designation of the firm. In the U.S., there is one basic registration form for "brokers or dealers," but specific requirements come into play at any time that a broker or dealer registered under the statute engages in underwriting, acts as broker for a customer, or performs some other function in connection with his securities business.<sup>1/</sup>

---

<sup>1/</sup> American "investment companies" and "investment advisers" are required to register separately, but the fact remains that a "broker or dealer" may perform most activities in the securities industry with only one registration.

(d) Recommendations

I. Firms engaged in, or wishing to enter, the securities business, whether or not as exchange members, should be required to register with the Government and to file certain basic information, such as name and address of principals, addresses of offices, type or types of business to be conducted, and financial data. Such firms should also be required at all times to maintain minimum capital commensurate with the risks of the business conducted and the commitments undertaken.

II. Persons entering the securities industry, either as principals or employees of firms, should be required to meet high qualifications standards, both as to competence and character. Such individuals should be required to pass an examination testing their knowledge of the securities business and applicable regulations.

III. Exchange membership should be opened up to all qualified firms. In particular, firms with experience in the exchange bill or other related businesses should be encouraged to join a stock exchange, since their participation and their capital will be important, and indeed necessary, if the stock exchanges are to perform their proper function in the Brazilian economy. The membership of the Rio and Sao Paulo exchanges should be enlarged; we make no recommendation as to whether there should be a maximum number of memberships.

IV. The commission rate on exchange transactions should probably be raised, but the appropriate rate of commissions should not be fixed until further data on the income and expenses of brokers has been obtained. A descending scale of rates, depending on the amount of money involved, which the Central Bank has been considering, appears to be a reasonable rate structure. Methods should be found to enforce the rules against rebates of commissions.

V. Any increase in the commission rate should be dependent upon brokers providing adequate services to customers with respect to handling and delivery of securities, maintaining adequate and up-to-date records, and research services. One possibility would be to increase the commission rate in several steps, with each step dependent upon the achievement of certain results in these areas.

VI. Every effort should be made to keep the regulation of brokers as simple and workable as possible. While the rules to be adopted under the Capital Markets Law should regulate specific activities (e.g., distributions, trading) and contain specific prohibitions (e.g. against fraud and manipulation), it would be desirable for these rules to create as few legal distinctions as possible between different kinds of participants in the securities markets. Thus, in order to simplify the system and reduce regulatory burdens, there might be only one form of registration, regardless of the activities that a securities firm is planning to conduct.

4. Distributions of Securities

Considering the present degree of industrialization of Brazil, there are very few companies whose stock is publicly held. As a practical matter a Rio investor interested in purchasing corporate shares has fewer than 50 stocks to choose from, and it is doubtful whether he could obtain a quick execution of an order in more than half that number - the stocks on the "principal market" of the Rio Stock Exchange.<sup>1/</sup>

There are several reasons for the paucity of publicly held stocks. First, there has not been a strong securities industry to underwrite and distribute corporate shares.<sup>2/</sup> Secondly, most business enterprises in Brazil are family-held concerns and have a strong reluctance to allow outsiders to share in control. Thirdly, standards of disclosure have been so low as to discourage the purchase of shares. Finally, publicly held companies have placed very little importance on their relations with their stockholders. The Government has recently taken a number of steps designed to induce companies to "go public" and investors to purchase newly issued corporate shares.<sup>3/</sup>

---

<sup>1/</sup> See Section 5.

<sup>2/</sup> See Section 3.

<sup>3/</sup> Persons with whom he talked in Brazil estimated that there are at least 200 closely held companies with net capital of more than Cr \$1 billion (\$550,000). In general, it is at these companies that the Government is aiming in its efforts to broaden the market in equity issues.

(a) Underwriting of New Issues

Until recently, very few distributions of securities in Brazil were underwritten. We understand that in the early 1950's Deltec, an important investment firm, and IBEC, which manages Crescinco, Brazil's largest mutual fund, underwrote a few issues of securities, using their large sales organizations to distribute them. These issues were not successful, however, and few underwritings have been attempted since then. In 1964, new issues of capital by Brazilian corporations (aside from reappraisals of assets, owing to inflation) totalled approximately Cr. \$800 billion (\$430 million). Most of these issues apparently did not involve underwriters.

During the past few months there has been a revival of interest in underwriting. In September 1965, Mesbla, the department store chain, issued Cr. \$6.6 billion (\$3.6 million) of new securities through a syndicate of 14 underwriters.<sup>1/</sup> Two things about this are significant: first, the underwriters were taking advantage of a provision of the Capital Markets Law which for the first time permits syndications and, secondly, several of the underwriters were major investment, credit, and finance firms that had hitherto undertaken commitments principally in exchange bills rather than stocks. This underwriting may be an indication that the Government's efforts to encourage such firms to participate in the "share business" are succeeding.

Most Brazilian companies are originally organized by private (as opposed to public) subscription, and Brazilian law gives existing

---

<sup>1/</sup> Mesbla has been a public company since 1944. Forty-seven percent of its capital of Cr. \$32 billion is owned by 12,000 public stockholders. The remaining 53 percent is owned by officers, directors, and employees and members of their families.

shareholders a preemptive right to subscribe to all new shares authorized for issue. Hence, a company which decides to go public must issue to its shareholders subscription rights to purchase the new shares, and the shareholders either exercise the rights, sell them to the public, or fail to exercise them. In the latter case, the company's underwriters then may subscribe and sell the subscribed shares to the public. In the Mesbla underwriting, the underwriters took down approximately 900,000 shares, or 15 percent of the issue. As compensation they received a commission of one percent of the entire issue plus a slightly larger fee for the unsubscribed shares. There has also been a certain amount of "best efforts" underwriting, in which the underwriter acts as agent for the company, without making any commitment to take down any part of the offering.

The question of market support operations should receive careful consideration in connection with the drafting of regulations under the Capital Markets Law.<sup>1/</sup> On the one hand, perhaps the principal reason for the lack of public interest in newly issued shares is the fact that in a number of instances in the past no market for such shares continued after the distribution was completed. On the other hand, it is not uncommon for underwriters to support the price of a stock during its distribution to the public. This was done, for example, in the Mesbla offering.

---

<sup>1/</sup> The statute provides that the National Monetary Council shall fix rules for the stock exchanges with respect to "the conditions to be observed in authorized price-maintaining operations."

One Sao Paulo securities dealer told us that he facilitates distributions of securities by promising to maintain a market in them both during and after the distribution. He locates closely held companies that he thinks have good investment potential, convinces the controlling interests to sell a portion of their holdings to the public, and then works up interest in the security among brokers and institutional investors. He will also purchase stock for his own clients and for his own account. During the past five years, he seems to have had considerable success in this type of operation.

While it is important to assure that a trading market in a security will exist after its distribution so that investors can have confidence that they will be able to liquidate their holdings, market support operations immediately before or during a distribution contain a dangerous potential for manipulation. In the U.S., awareness of this problem has led to the adoption of rules that in general prohibit such purchases by underwriters and other participants in a distribution, except in conformity with certain strict requirements.

(b) Tax Provisions

Probably the most important step that the Government has taken to encourage companies to issue their shares to the public are the tax

provisions of the Capital Markets Law. These provisions give favorable income tax treatment to the stockholders of "open companies," a term that is left to the National Monetary Council to define.

Under the new law dividends of holders of registered shares or holders of bearer shares who identify themselves are taxed at ordinary income-tax rates (which range from zero to 65 percent) subject to an annual deduction of Cr. \$600,000 (\$325). Dividends of holders of bearer shares who do not identify themselves are taxed at a flat rate of 25 percent, which is required to be withheld at the source. For companies not defined as "open companies," the withholding rate is 40 percent and the Cr. \$600,000 deduction is not given. These income tax rates on dividends may be compared with a rate of 84 percent two years ago and 65 percent last year. One effect of the new provisions will be to induce lower-income investors (those with a tax rate of under 25 percent) to identify themselves and higher-income investors to purchase bearer shares and not identify themselves.

The crucial question will be how the Government defines "open company." This definition will be doubly important since, in addition to affecting the taxation of dividends, it will undoubtedly serve as a kind of "listing standard"

that will determine the place and method of trading of a company's stock. Section 5 of this report indicates that only the more active stocks are traded in the "principal market" of the Rio exchange and recommends that such stocks be traded continuously rather than under the present "call" system. Furthermore, suggestions have been made that, as in the U.S., only stocks that meet certain listing standards be permitted to be traded on the major stock exchanges. For these reasons it is important to give the question of the definition of "open company" close scrutiny.

We understand that the Central Bank is considering requirements of three basic kinds: (1) those relating to stockholders' rights; (2) those relating to distribution of securities; and (3) those relating to trading activity. <sup>1/</sup> We agree that providing favorable tax treatment (and perhaps a good trading market) may be an effective method of increasing the rights of public stockholders. <sup>2/</sup> We believe that distribution requirements should provide the basic criterion as to whether a company should be considered open. It is not clear, however, whether it would be desirable to require that publicly

---

<sup>1/</sup> One proposed definition would require that public stockholders have equal rights (except voting rights) with those of insiders; that there be a minimum number of stockholders; that a minimum percentage of capital be in public hands; that the stock be listed on an exchange or that listing be contemplated; and that minimum trading requirements be as follows: trading on 3 out of 5 days of the week and 3/4 of the days of the month; weekly volume of Cr. \$8 million and monthly volume of Cr. \$ 40 million; and 2 percent of total number of shares must be traded in a period of six months.

<sup>2/</sup> See Subsection (d).

held shares constitute a minimum percentage of total capitalization. While market control by insiders <sup>1/</sup> may in some instances be a problem, it can be attacked in other ways, such as by enforcing strict rules against manipulative activities. In the case of large companies, a good trading market should be possible if there is sufficient distribution in terms of number of publicly held shares and of stockholders, even though the publicly held shares constitute a distinct minority of the total number outstanding.

The third category of requirement is troublesome. We understand that the Government is proposing to require that for a company to be an "open company" there must be a minimum amount of trading in its stock. We question the wisdom of using such a test as a touchstone for determining a company's tax treatment. First, and most obviously, such a requirement would constitute a virtual invitation to stockholders to engage in unnecessary or "wash" sales to ensure receiving the tax advantages accorded to open companies. Secondly, it does not seem advisable for the Government to determine how much trading in a company's stock there should be. Once a company's shares have been distributed

---

<sup>1/</sup> We have been told that insiders of certain banks and other publicly held companies effectively control the market price of their stock.

to the public, trading in them ought to be left to the forces of the market place. Investors may put aside the shares of one company as a long-term investment and trade frequently in the shares of another company for short-term speculation. There does not seem to be any adequate justification for giving the latter company more favorable tax treatment than the former.

(c) Problems of Disclosure

Prior to the adoption of the Capital Markets Law, a company proposing to raise its capital by public subscription was required to publish a prospectus in the official gazette and a newspaper of general circulation. The prospectus was required to be a "clear and precise exposition of the bases of the company and of the motives or reasons the founders have for their expectation of the success of the enterprise."<sup>1/</sup> Among other things, it was required to disclose the composition of the company's capital; a detailed description of the properties which are to be appraised prior to their inclusion as part of capital; the nominal value and subscription terms of the shares; the obligations and commitments assumed by the founders and the contracts signed in the interest of the future company, as well as any amounts spent or to be spent; any special privileges to be afforded the founders or third parties; and the name, nationality, profession, and residence of the founders, the number of shares for which they have subscribed, and the name of the person having custody of the originals of the prospectus, for examination by any interested party.

These prospectus requirements were not of any great practical

---

<sup>1/</sup> Brazilian Company Law, Sec. 40.

importance, since most companies are organized by private subscription, and no prospectus was required when subscription rights, or the shares subscribed were subsequently offered to the public.

The Company Law also requires companies to publish an annual balance sheet and profit and loss statement, and to file the same information with the exchange upon which the company is listed.<sup>1/</sup> The manner in which companies comply with these requirements varies according to their own attitudes on disclosure. Most balance sheets are very meager and uninformative. There are no uniform standards and no enforcement of the requirements of the law.

Some underwriters attempt to investigate the company whose shares are to be offered to the public and are able to obtain some degree of cooperation, especially if the company is eager to effect a public distribution of its shares. Some companies are reluctant to disclose any information, even to underwriters, partly no doubt to avoid taxation and partly because of a traditional addiction to habits of secrecy. Other companies have voluntarily made disclosure of corporate information, perhaps in order to inspire confidence on the part of potential investors.

Under the Capital Markets Law, no issue of stock may be "launched, offered publicly, or have its floating on the market initiated,"<sup>2/</sup> unless it is first registered with the Central Bank. The application for registration must include a copy of the prospectus and any other written material to be used in connection with the offering. The

---

<sup>1/</sup> Companies, including those that are closely held, are required to list their shares and bearer bonds with the stock exchange closest to their principal office. Decree Law 9733, Sept. 6, 1946.

<sup>2/</sup> Sec. 21.

law gives the National Monetary Council broad power to adopt rules as to what must be disclosed, with regard to the issuer or guarantor of the issue, its economic and financial situation, administration, and controlling stockholders; the securities to be offered; and the persons who will take part in the offering. Furthermore, the National Monetary Council is directed to publish rules for the periodic publication of information by companies registered at the Central Bank, including rules with regard to "the organization of the Balance Sheet, and the way in which the results are shown, the norms for the accounting system, and the reports and opinions of independent auditors registered by the Central Bank."<sup>1/</sup> The Central Bank has power to suspend or prohibit the floating of stock, "the offer, launching, announcement or promotion of which is being done in conditions other than those provided by the registration of the issue, or by publishing false or manifestly tendentious or imprecise information"; or "the issuance of which has been judged to be illegal or fraudulent, even though at a date later than the relative registration."<sup>2/</sup>

---

<sup>1/</sup> The statute also provides that no private company may have its stock traded on a stock exchange unless the company has been registered at the Central Bank. See Secs. 19 and 20.

<sup>2/</sup> Sec. 21, para. 3.

We heard conflicting points of view on the amount of corporate disclosure that should be required by the rules to be adopted under the Capital Markets Law. Some stock exchange members and representatives of investment firms said that full disclosure by corporations coming to the public for funds will create confidence among investors and thus facilitate the distribution of securities. On the other hand, one company official said that any substantial disclosure requirements will deter companies from seeking financing from the public. It may well be, however, that the incentive of tax benefits and the necessity of obtaining financing will as a practical matter outweigh the reluctance of such companies.

As American observers, we cannot avoid being influenced by the fact that the securities markets in the U.S. operate against a backdrop of "full disclosure." It may be that there is a close connection between the availability of reliable information concerning companies and the broadness of the base of public interest in securities. Usually when a company or controlling persons go to the public for financing, the company must file a very complete registration statement with the SEC; and there are rules requiring delivery to customers of a prospectus in prescribed form containing a large number of items of information and including financial statements certified by an independent auditor. Furthermore, all listed companies and the larger over-the-counter companies are required to file periodic and interim reports and comply with certain rules in the solicitation of proxies, and insiders must report their trading in the equity securities

of the company and pay back to the company any profits derived from short-swing trading in such securities.<sup>1/</sup> Besides these Federal requirements, companies are subject to additional requirements imposed by the exchange on which they may be listed. The New York and American Stock Exchanges, for example, require listed companies to publish quarterly reports and to make prompt disclosure of any corporate information that may affect security prices.

We are not suggesting that the Government of Brazil adopt the full panoply of disclosure requirements that exist in the U.S. Yet the Capital Markets Law appears to contemplate that basic corporate disclosures be made and that standards of truthfulness be established and followed. For example, it is to be expected that the National Monetary Council, in its implementation of Section 20 of the Capital Markets Law, will prescribe the form and content of the financial statements that publicly owned companies will be required to file. Similarly, information about the company, its management, capital structure, and business; and the proposed use of the funds being raised should certainly be disclosed as a matter of course. (This list is not intended to be exhaustive but only to suggest certain key areas.)

Likewise, annual financial statements, in prescribed form, should be required of all companies. In general, the only Brazilian companies

---

<sup>1/</sup> The Brazilian Capital Markets Law seems to contemplate regulation of trading by insiders. See art. 3 (X).

that use independent auditors are those that are subsidiaries of foreign companies. Every Brazilian company is required to have a "fiscal council" of at least three persons, who are elected annually by the shareholders. The fiscal council is supposed to exercise oversight of the company's financial management on behalf of the shareholders. It has authority to examine the company's books and it must give its approval to financial statements before they are published. In practice, however, the council does not conduct its own audit but relies on the board of directors. It appears to be a very inadequate substitute for an independent auditor as a watchdog of corporate finances. We would recommend that consideration be given to the establishment of a requirement that financial statements contained in registration statements, prospectuses, and annual reports be certified by an independent auditor.

(d) Shareholder Relations

We understand that few Brazilian companies give their public shareholders the same rights as those of the group that is in control. Several publicly held companies have issued "preferred" stock to the public, which is identical to the "common" stock held by the insiders except that it does not carry voting rights. We were told of one recent real estate venture for which all of the financing was obtained from the public, but these public investors were given no voice in management.

Furthermore, Brazilian companies generally do not provide services to their public stockholders which in the U. S. would be considered normal. Stockholders usually have to appear at the company's offices to collect dividends, bonus shares, or other distributions. They are made to wait in line while the appropriate papers are processed and the dividend paid over. For holders in distant parts of the country, this system is very onerous unless they employ a broker or other agent in the city where the company has its distribution office.

In the case of nominative (registered) shares, transfers are effected by the companies at their offices. Bearer share certificates are now being issued in multiples of 100 shares, but it is still frequently necessary to have a certificate for more than 100 shares broken down into certificates of smaller denominations. This process can be accomplished only at the company offices, although the Rio exchange has adopted a clearing system whereby the exchange undertakes to do this and issues interim receipts which can be traded. When a company has a stock split, however, the holder must turn in his share certificate and wait for the company to issue the new split shares. This may take several months, during which time the owner cannot sell his shares.

The Capital Markets Law allows registered shares to be transferable by endorsement, but endorsable shares are not yet being issued by companies. The law requires companies to keep a list of stockholders and to record transfers. Distributions by the company are required to be made on the

basis of this registration. The company is authorized to delegate the registration and transfer functions to a broker or financial institution.

(e) Recommendations

I. Consideration should be given to the adoption of rules under the Capital Markets Law that will eliminate the potential manipulative effects of price support operations in connection with distributions of securities.

II. The tax provisions of the new statute give favorable treatment to stockholders of "open companies." In defining this term, we recommend that the Government set standards in terms of rights of stockholders and minimum distribution of shares; but we question the advisability of also requiring a minimum volume of trading for a company to be considered "open."

III. Requirements should be set for basic disclosures to be made when companies or their controlling persons go to the public for financing. Such disclosures should at least include information about the company, its management, capital structure, finances, business operations, and the proposed use of the funds being raised. Rules should also be adopted prescribing the form and content of financial statements, and consideration should be given to a requirement of periodic financial reporting and of certification of financial reports by an independent auditor. Prospectuses should be signed by the underwriters as well as by the company or the selling stockholders, and responsibility should be placed on the underwriters to make inquiry into matters contained in the prospectus. Procedures should be established for review of such filings and reports by the Central Bank.

IV. Companies should be encouraged to make the rights (including voting rights) accorded to public stockholders more nearly equivalent to those of insiders; improve the servicing of dividends and transfers; and generally to make the purchasing, holding, and selling of corporate shares more convenient for public investors.

5. The Trading Market

(a) Trading Data

During the past decade the volume of trading on the two principal Brazilian stock exchanges has grown dramatically. Between 1952 and 1964, the value of shares traded annually on the Rio and Sao Paulo exchanges increased from Cr \$ 451 million to Cr \$ 76,858 million. Most of this increase was due to inflation, but if the 1964 figure is deflated to its 1952 purchasing power, the figure is still Cr \$ 2,373, representing a five-fold increase.<sup>1/</sup>

About 6,000 stocks are registered on the Rio exchange, but only about 50 of these are traded with any regularity,<sup>2/</sup> most of the trading being concentrated in 10 or 12 issues. The companies whose shares are traded are in a variety of industries, including textiles, metals and mining. Among the most active stocks are Brahma, a beer and soft-drink company; Belgo Mineira, a mining company; Souza Cruz, a cigaret manufacturer; and Meebla, a company that owns a chain of retail stores. Most shares trade at a price of under Cr \$3,600 (\$2), and daily volume in amount of money rarely exceeds Cr \$1 billion (\$550,000).

Until recently, very little trading in stocks took place off the exchange, but during the past few months some investment companies and

---

<sup>1/</sup> A Economica Brasileira e suas Perspectivas (Apec 1965), Table D-1.

<sup>2/</sup> The discussion in this section of the report concentrates on the Rio de Janeiro Stock Exchange, which is far more important than the Sao Paulo Stock Exchange in terms of transactions in shares. Most of the observations herein are applicable, however, to both exchanges.

exchange members have been trading exchange-listed stocks "off-board". We have been told that the trading volume of this "telephone market" amounts to about 20 percent of exchange volume, but no statistics are available to confirm this.

Using the daily sales sheets published by the Rio exchange, we have made a simple statistical study of price and volume fluctuations on the so-called "principal market," where the more active stocks are traded. For this purpose, we used the sales sheets for a three-week period from September 13 to October 1, 1965 and for one day each week for four weeks before and two weeks after this period. The following table shows trading data for the three-week period:

<u>Date</u>	<u>No. of Shares Traded</u>	<u>Stock Price Index*</u>	<u>Daily Change In Index</u>	<u>Advances (+)</u>	<u>Declines (-)</u>	<u>Unchanged</u>
9/13/65	311,602	101	+ 1	15	5	3
9/14/65	419,521	101	nc	8	15	0
9/15/65	432,775	96	- 5	1	22	0
9/16/65	360,000	93	- 3	0	23	0
9/17/65	442,430	89	- 4	2	21	0
9/20/65	291,814	92	+ 3	16	6	1
9/21/65	358,285	95	+ 3	19	3	1
9/22/65	(Trading data not available)					
9/23/65	346,599	99	+ 4	23	0	0
9/24/65	397,635	95	- 4	2	21	0
9/27/65	299,135	93	- 2	5	18	0
9/28/65	258,530	93	nc	10	11	1
9/29/65	237,589	99	+ 6	15	7	1
9/30/65	291,670	100	+ 1	14	6	2
10/1/65	420,396	100	nc	11	8	4

\* Based on a base price of 100 for August 16, 1965.

As the table shows, the Rio exchange's stock index fluctuated between a high of 101 and a low of 89. On a weekly basis, the index showed changes of minus 11, plus 6, and plus 5 for each of the three weeks, thus showing no net change for the three-week period. The number of shares traded daily varied from 442,430 on September 17 to 237,589 on September 29. On that day the index gained 6 points, the largest daily fluctuation noted during the period. On 11 of the 14 days analyzed, the great majority of the stocks traded were either advancing or declining at the same time.<sup>1/</sup> The tendency of stocks to move in the same direction was confirmed by the observations of brokers and company officials with whom we talked, who said that, owing largely to a lack of available corporate information, stock prices tend to move on the basis of rumors of news about the general political or economic situation rather than on information about the financial condition or prospects of an individual company.<sup>2/</sup>

---

<sup>1/</sup> On each of these 11 days, at least twice as many stocks advanced as declined, or declined as advanced.

<sup>2/</sup> See Section 4.

The trading for one day each week during four weeks before and two weeks after the period discussed above reveals a similar pattern, with fluctuations in price and volume even more pronounced. Daily volume on the days analyzed ranged from 228,537 to 781,824 and on one day there was a change in the price index of minus 11, or approximately 11 percent. The tendency of stocks to advance or decline together was noticeable on all but one of the six days analyzed.

A study also was made of changes in price of individual securities on the Rio exchange during the week ending September 17, 1965, when the price index declined 11 points and 21 of the 23 securities traded showed net losses. During this period, one security, Petrobras (the national oil company) declined 26.4 percent, while other stocks declined 22 percent, 19 percent, 18.8 percent, 17.8 percent and 16.4 percent. Eight stocks had net losses for the week of between 10 and 15 percent, 7 stocks had losses of between 5 and 10 percent, and 2 stocks had gains of 4.5 percent and 1 percent. Daily fluctuations during this period ranged from a gain in one stock of 12.1 percent and a loss in one stock of 19.2 percent.

Trading volume in individual stocks in the principal market varies greatly.<sup>1/</sup> For example, on September 17, 1965, a day selected at random, on which the total volume was 442,400 shares, the most active stock traded 95,700 shares, while the least active traded 1,700 shares. The following table shows the activity of individual stocks for the day:

<u>No. of Shares</u> <u>Traded</u>	<u>No. of</u> <u>Stocks</u>
0 - 1,999	2
2,000 - 4,999	4
5,000 - 9,999	6
10,000 - 19,999	7
20,000 - 49,999	1
50,000 and over	3
	<hr/> 23

The volume of trading on the "secondary" market for the same day was 143,696 shares, but 105,042 of these shares were in a single stock.

The following table shows the activity in individual stocks:

<u>No. of Shares</u> <u>Traded</u>	<u>No. of</u> <u>Stocks</u>
0 - 99	3
100 - 499	6
500 - 999	3
1,000 - 1,999	3
2,000 - 4,999	4
5,000 and over	2
	<hr/> 22 <sup>2/</sup>

---

<sup>1/</sup> For an explanation of the "principal" and "secondary" markets, see pp. 42-45.

<sup>2/</sup> Some of the stocks of the secondary market were not traded at all on September 17, 1965.

(b) Influences on Stock Prices

Price fluctuations of the magnitude shown in our statistical study, which we understand are not unusual, cannot but reduce the public's confidence in the stock market. If 20 percent or more of an investment can disappear in a single day, even though no adverse information concerning the company has come to light, it is hardly surprising that an investor may hesitate to purchase stocks.

These fluctuations, which are caused by the "thinness" of the market, the lack of corporate information on which to base sound investment decisions, and the small number of investors, make it relatively easy for stock prices to be influenced improperly. Several persons told us that it is not uncommon for stocks on the Rio exchange to be manipulated. Instances were brought to our attention in which investment firms allegedly spread false information about a stock, while they simultaneously sold their shares on the Exchange. We were also told that groups of persons, including both Exchange members and nonmembers, engaged in prearranged sales with each other simply in order to drive up the price of a stock. We are not, of course, in a position to evaluate the reliability of these statements, but the evidently widely held belief that the market is not an open and fair one, whether justified or not, undoubtedly has deterred potential investors from purchasing corporate stocks.

Aside from such improper practices, the small size of the stock market, in terms both of number of shares traded and of number of investors, creates problems. As a result, the trading of one large investor may

have a decided influence on prices, even though this may not be his purpose. A case in point is Crescinco, which is by far the largest mutual fund in Brazil, with approximately Cr. \$34 billion of assets and 16,000 shareholders. Crescinco accounts for approximately 7 percent of the trading on the Rio exchange, and its holdings of some companies comprise up to 25 percent of the total number of shares in the hands of the public. As a consequence, Crescinco has been accused of influencing the market. During 1964, for example, redemptions by fund shareholders obliged it to sell portions of its portfolio on the Exchange. These sales were said to have contributed substantially to the decline in prices that took place. Crescinco's relative importance in the market is largely attributable to the fact that there are few other institutions that have any significant activity in corporate stocks. In general, banks and life insurance companies are not accustomed, or are not permitted, to use this form of investment.

Another problem is that Crescinco's somewhat unique position leads members of the Exchange, as well as nonmember speculators, to attempt to find out when the fund is about to make significant purchases or sales and to trade on the basis of such knowledge. We understand that Crescinco has met this problem with some success by using three or four brokers to execute their orders and by changing brokers from time to time.

It would be unfair to criticize Crescinco for its influence in the market, which is apparently a result of its size in relation to

other investors. Nor do we believe that the solution to the problem is to discourage this enterprise. To the extent consistent with safety and investment objectives, other institutions should be encouraged to invest in corporate stocks. As the market expands and the number of shares available for trading, as well as the number of investors, increases, the problem of wide price fluctuations can be expected to become less troublesome. Meanwhile, regulatory controls should be exercised to prevent manipulative activities.

(c) The System of Trading

Under the trading system in use on the Rio and Sao Paulo exchanges, bids and offers of members of the investing public are designed to meet in an auction market without any professional intermediary. In fact, as indicated in Section 3, exchange members are not permitted to trade as principal. This system differs sharply from the jobber system of the London Stock Exchange or the specialist system of the New York Stock Exchange, where dealers to a greater or lesser degree interject their own trading between purchases and sales by members of the public.

The system of trading used on the Rio de Janeiro Stock Exchange was derived from that of the Paris bourse in the late 19th century. The trading floor consists of a series of concentric circles, which is known as the "corbeille" (French for "basket"). The members of the exchange (or their substitutes) stand at assigned places around the innermost ring of the circle, facing each other. Behind them in the next ring are the clerks, who have telephones connecting with the members' offices, and behind the clerks members of the public are allowed to stand.

Trading begins at 10 A.M. and continues for approximately two or three hours. The president or vice president of the Exchange stands at a raised desk in the inner ring and calls out the stocks one by one. Immediately a stock is called, the members begin to trade with each other, shouting out their bids and offers and using various kinds of hand signals. Each stock is traded for between 10 and 30 minutes, depending on the amount of trading interest. When a sale is made, a clerk in the center of the ring picks up the order slips from the buying and selling brokers, compares them, and places them in a tube which connects with a quotation board on the wall, where exchange employees chalk up the number of shares and price of each transaction. The order slips then go to the clearing house<sup>1/</sup> of the Exchange. The brokers retain a carbon copy of the order slips, which are used for posting the transactions in the firm's books, and for effecting delivery or payment through the clearing house.

In view of the actual and expected expansion of the Brazilian capital markets, this system of trading has certain limitations. First, the trading circle has a limited amount of space. If membership in the Exchange is to be opened up to qualified firms that are not now members there will be no room for these firms to conduct their trading unless the system is changed. To build a larger trading circle is not the answer; even today, the noise and confusion are not conducive to orderly markets. Several brokers told us that it is quite possible under the present system

---

<sup>1/</sup> The Sao Paulo Stock Exchange has no clearing house, and transactions are settled directly between brokers.

to miss the best bid or offer being made at a given moment, and that stocks are frequently traded simultaneously at two or more different prices. Furthermore, the fact that there is only a brief period during which each stock may be traded tends to force purchasers or sellers who are anxious to obtain an execution on a given day to compromise unduly on the price, since brokers on the other side will hold out for a better price.

As volume of trading increases, it is becoming increasingly difficult to limit a day's trading in a particular stock to a few minutes each day. In fact, the "telephone market" has recently diverted orders in listed stocks from the Exchange partly because of this limitation on the Exchange's trading system. Rather than wait until the next day's trading and take a risk on the price changing, some customers prefer to trade "over the counter" after trading hours. It may be expected that as the number of stocks traded on the Exchange and the trading volume in these stocks continue to increase, this problem will become increasingly acute.

The Rio exchange has recently established a separate "secondary market" for stocks with below-average trading volume. Thirty stocks were placed in the secondary market, leaving 23 stocks to be traded in the principal market. Secondary-market stocks are traded on a purely mechanical basis in a room adjoining the main floor of the Exchange.

Orders at limited prices <sup>1/</sup> are submitted to an exchange employee by brokers' assistants who prepare a table showing all bids and offers at each price. A single price is then determined at which a maximum number of orders can be executed. This price, however, may not be more than 5 percent away from the price at the previous auction, except that if a stock is not traded at a given auction, the price limitation will not apply at the next auction. When the secondary market was first established there were three auctions each day, but this was found to be impractical since there was not enough time between auctions for customers to ascertain whether their orders had been executed at the previous auction. There are now only two auctions each day.

The secondary market has certain disadvantages of its own. It does not permit the use of market orders, <sup>2/</sup> no brokerage judgment can be exercised in executing an order, and many orders of customers do not get executed. It should be recognized that one reason for establishing a mechanical system was that most of the brokers' assistants who bring orders to the secondary market are relatively untrained persons to whom a broker

---

<sup>1/</sup> Limited price orders state the highest price at which a customer will buy or the lowest price at which he will sell.

<sup>2/</sup> A market order is an order to buy or sell at "market"; i.e., normally the best prevailing offer or bid at the time that the order comes to the exchange floor.

would not be inclined to give discretion.

In 1965 a standard unit of trading, or "round lot," of 100 shares was established for stocks traded in the principal market, in order to facilitate trading. Under this system, orders of fewer than 100 shares, or "odd lots," are handled separately. Odd lot orders are matched with each other to the extent possible, and the Exchange itself has established a fund that purchases or sells any excess at a single price that is closely related to the round-lot price of the stock. The Exchange designates a member to handle odd lots as its agent, while his brokerage business is attended to by a substitute. In the secondary market there is no round-lot unit of trading, and orders of all sizes are handled together.

(d) A Continuous Auction Market--the SNI Plan

In December 1964, the Rio exchange retained the Servico Nacional de Investimentos (SNI) to prepare a plan for the modernization of the Exchange.<sup>1/</sup> In June 1965, SNI gave the Exchange a detailed plan for changing the system of trading and automating the execution of orders. Furthermore, the plan proposes that the Exchange establish telex and teletype systems connecting all local brokers with the Exchange, which eventually would be expanded to include brokers throughout the country; conduct a publicity campaign to induce the public to invest in corporate securities; and organize a central clearing system that would also act as a depository for customers' cash and securities and a credit agency for margin transactions.<sup>2/</sup>

The SNI report recommends that the trading system of "calling" out securities one by one be abolished. This system would be replaced by a continuous auction market, in which each stock would be traded at a particular "post" on the floor of the Exchange throughout each trading session. Trading would be fully automated. A broker with a customer's order to buy or sell a stock would go to the post at which the stock was traded. He would be able to ascertain the "market" for the stock by pressing a button, and an electronic board would inform him of all existing bids and offers for that stock.<sup>3/</sup> He

---

<sup>1/</sup> This firm publishes an investment service and manages a small mutual fund.

<sup>2/</sup> At the present time, owing apparently to the tight credit policy of the Central Bank, it is not feasible for investors to purchase shares on margin.

<sup>3/</sup> Revealing all bids and offers might create problems, since it would give potential manipulators the ability to predict exactly how many purchases (or sales) will move the price a given amount. Moreover, investors would be likely to refrain from entering their bids and offers into the system. It might be preferable to reveal only the highest current bid and the lowest current offer (the "market" for the stock).

would then be able to enter his own bid or offer into a data-collecting machine or to hit the prevailing bid or offer and obtain an execution. Under such a system, as under the existing system, members of the public would trade with each other without the intervention of any professional dealer or market maker.

The basic change in the trading system that the SNI plan contemplates, namely the change from a "call" system to a continuous auction market, appears desirable, at least for the more actively traded securities.<sup>1/</sup> As we have seen, the call system appears to have a constricting effect on the market for the more active stocks, several of which, as we have seen, trade more than 10,000 shares (or 100 round lots) per day. We question the wisdom, however, of adopting a continuous auction trading system without providing for some sort of institutionalized dealer participation in the market. Without this, it is quite likely that short-term fluctuations in stock prices will become even more extreme than they already are. Since trading that is now concentrated in less than half an hour would be

---

<sup>1/</sup> Determination of which stocks should be included might depend on standards similar to the listing requirements of the major U.S. exchanges. In general, these are: number of shareholders, number of shares outstanding that are publicly held, record of earnings, and value of assets. An additional standard might be previous trading volume. See the discussion of the tax provisions of the Capital Markets Law in Section 4 of this report.

spread out over the entire trading session, there would be less chance that a customer's order to buy stock would simultaneously meet another customer's sell order. A well-run dealer system would tend to even out momentary disparities between supply and demand. It would also ensure that an investor could obtain an immediate execution at any time during the trading session at a price reasonably related to the price at which the stock was last traded.

A brief description of the specialist system that is employed on the major United States exchanges may be helpful in this connection. Specialists are stock exchange members who "specialize" in some or all of the securities traded at a particular location or "post" on the floor of an exchange. They are registered with the exchange of which they are members and are allocated a number of stocks in which they are responsible for "making a market."

A specialist has two basic functions: First, he holds and executes orders to buy or sell stocks in which he specializes, which are entrusted to him by other brokers on behalf of their customers. These are generally orders which cannot be executed immediately because the price at which the customer wishes to buy or sell is away from the current market price of the security. Thus, if the market for a stock is 10 bid, 10½ offered, the specialist would generally hold limited-price orders that cannot be executed against the current bid or offer (e.g., the order of a customer unwilling to sell below 11).

Secondly, a specialist purchases and sells securities for his own account in order to assist in maintaining a fair and orderly market in each security in which he is registered. In this capacity, a specialist buys or sells securities in the public market when there is no public demand at a price reasonably close to the last transaction. In general, his contribution to a fair and orderly market is to use his own capital to minimize temporary

disparities between supply and demand and thus to help maintain price continuity.

The specialist is allowed to interject himself into the market as dealer only if to do so is reasonably necessary to maintain a fair and orderly market. Specialists on the New York and American Stock Exchanges participate in approximately 25-30 percent of all transactions. If, for example, the highest public bid is 10 and the lowest public offer is 10 1/2, the specialist might quote his own market at, say, 10 1/8 bid, 10 3/8 offered. A broker coming to the specialist with an order to purchase stock at the market price would then get an execution at 10 3/8. Similarly, a market order to sell would be executed at 10 1/8. Both the buying and selling customer would obtain a better execution than if the market were a purely public market, and the specialist would in effect be paid for his services by getting the "jobber's turn" (buying at 10 1/8 and selling at 10 3/8).

This is not to suggest that the Brazilian stock exchanges adopt the specialist system exactly as it exists on the major U.S. exchanges, but rather that consideration be given to the establishment of a continuous auction market system of trading, with professional dealer participation of some kind. The form that the system actually takes will have to be adapted to the needs and capabilities of the Brazilian market. For example, it might possibly be advisable to spread the risks (and profits) of "market-making" over the entire membership of the exchange rather than to concentrate them on a few firms. In such case, specialists might be capitalized by an exchange fund to which all members would contribute and in which they would retain an interest. Another important question that would have to be decided is the length of the daily trading session (or sessions). This would depend on such considerations

as the level of trading activity and the need of members to be in their offices during part of the day. A short session of two, or perhaps three, hours would probably be advisable at first, in order to avoid placing too heavy a burden on the dealers to minimize price fluctuations. The trading session could later be lengthened if this is warranted by increased volume. It might also be desirable to limit the daily price variation, as is done currently on the "secondary" market of the Rio exchange and on American commodities markets.

The important change in methods of trading that it is here suggested cannot be imposed by government fiat. The system would have to be worked out jointly by the Government and the securities industry, including investment, credit, and finance firms that are not exchange members at the present time. As stated in Section 3 of this report, these firms should be encouraged to become exchange members and bring their capital and skills to the market in corporate shares.

It is equally important that the Government play an active role in overseeing and possibly participating in the formulation and operation of the trading system, particularly in view of the exchanges' lack of experience as self-regulators. It should be recognized that a system of continuous trading in which the same persons may be simultaneously brokers and dealers creates regulatory needs not present in the comparatively simple trading system employed today on the Rio and Sao Paulo exchanges. Certainly the introduction of such a system would be dangerous unless there is adequate surveillance of the activities of professional dealers and other participants in the market. The problem of regulation will be discussed further in Section 6 of this report.

If the less actively traded stocks are to continue to be traded on the stock exchanges, <sup>1/</sup> we would not recommend a continuous auction market system of trading be employed. In such stocks, price fluctuations tend to be more extreme than in more active stocks; and the burden and the risks placed on a dealer or specialist charged with maintaining an orderly market would tend to be unreasonable great. Inactive stocks might be traded by the "call" method, with any exchange member having the privilege of requesting that any listed stock be called on a given day; or by the "cabinet" method, whereby bids and offers are left with a clerk and any broker wishing to trade in a stock can consult the "cabinet" and get the names of other interested brokers. Both methods are used in the U.S. for exchange trading in inactive stocks.

(e) The Question of an Over-the-Counter Market

There appears to be a lively discussion going on among interested persons in the Government and the securities industry of Brazil as to whether an over-the-counter market ought to be allowed to exist. The "over-the-counter market" is a term meaning all trading that does not take place on a stock exchange. The over-the-counter market is an important part of the U.S. securities markets, many stocks of industrial companies and nearly all bank and insurance stocks and government bonds being traded exclusively on that market. In addition, there is active over-the-counter trading in a number of listed securities.

In Brazil the picture is somewhat different. Listed on the Rio exchange are 23 relatively actively traded stocks, approximately 30 less

---

<sup>1/</sup> See the discussion of the possibilities of an over-the-counter market in the next subsection.

active stocks on the secondary market, and about 6,000 stocks that are seldom if ever traded. There does not appear to be any over-the-counter market, except for the "telephone market" in actively traded stocks<sup>1/</sup> and some price-support operations in recently distributed stocks by individuals or investment companies that have distributed the shares of companies to brokers and the public.

If, as recommended in Section 3 of this report, membership in the principal exchanges is opened up to all qualified securities firms (and especially if no limit is placed on the number of members), the participants in this over-the-counter market may voluntarily transfer their activities to an exchange. Representatives of one firm active in the "telephone market" told us that their firm would immediately seek membership on the Rio exchange if the restrictive admissions policy of that exchange is changed.

It is possible, however, that a number of firms, including those now engaged in the exchange bill business, will decide to act as brokers or dealers in corporate stocks without joining an exchange. If this should occur, the Government will have to determine whether to encourage, and indeed whether to allow, an over-the-counter market. In so doing, it should weigh several competing considerations. On the side of having an over-the-counter market are the competition it would provide with the exchanges in stocks that are traded on the exchanges; the fact that "unseasoned" stocks, which do not have wide distribution, are generally unsuited for continuous trading on an exchange; and the advantage of allowing the maximum degree of freedom to firms in how they run their own business. On the other side are

---

<sup>1/</sup> See p. 35.

the greater degree of surveillance that is possible over exchange transactions; the fact that it is easier to publish price and volume information about exchange transactions; and the greater depth, that concentration of all transactions in one place is likely to give to the market and the resulting possibility that customers will obtain better executions of their orders. The latter consideration may be especially relevant in view of the limited size of the Brazilian stock markets and the limited number of trained participants in these markets. We think that it would be advisable to defer making a decision on this important question until other recommendations of this report, especially those dealing with exchange membership and the system of trading on the principal market, have been implemented and until the degree of interest in instituting an over-the-counter market has been gauged.

If it is decided not to continue exchange trading of inactive stocks, such stocks could be traded at negotiated prices by investment firms, which would keep these stocks in inventory and would quote markets in them. Under such a system, only the more active stocks, which would meet specified listing requirements, would be traded on an exchange. Once a stock becomes "seasoned" in the market--after it has a minimum public distribution and the company has a history of earnings--it would be moved to an exchange for continuous trading. In general, this is the system in effect in the U.S. Again, we think that no decision should be made until the matter has received further consideration.

Since the only viable stock exchanges appear to be those in Rio and Sao Paulo, the above discussion is clearly inapplicable to other areas of Brazil. Moreover, telephone and other communications systems are relatively

undeveloped in Brazil today. For these reasons, in areas of the country other than those in which the principal stock exchanges are located, the existence of an over-the-counter market should be encouraged, particularly in stocks primarily of local interest.

(f) Recommendations

I. Rules should be adopted providing penalties for fraud and manipulation in the purchase or sale of securities, whether accomplished by transactions, by the spreading of false or misleading information to artificially affect the price of a security, or by other means.

II. The statutes and rules governing the investments that banks, insurance companies, and other institutions are permitted to make should be reviewed in order to ascertain whether it would be appropriate to allow more investment in high quality corporate stocks.

III. A continuous auction market should be substituted for the present system of trading on the principal stock exchanges, at least for the more actively traded stocks. Consideration should be given to introducing professional dealer participation, in which dealers would have affirmative obligations toward the market for the purpose of keeping it orderly and evening out temporary price fluctuations. The precise form that such a system takes should be determined after discussions have been held between the Government and the securities industry.

IV. We make no recommendation whether an over-the-counter market, either in inactive stocks or in those that are actively traded on an exchange, should be encouraged or even permitted in the Rio and Sao Paulo areas. Perhaps this decision should be deferred until further developments in the markets can be evaluated. An over-the-counter market outside the two major financial centers should be encouraged, at least in stocks of primarily local interest.

## 6. The Regulatory Needs

In evaluating the requirements for an adequate system for regulation of the Brazilian securities markets, it is necessary to examine the capabilities for self-regulation of the securities industry, the organization and objectives of the Government department charged with regulatory responsibility, and the role that might be played by USAID in providing technical assistance. In this section of the report, each of these areas will be discussed in turn.

### (a) The Self-Regulatory Capabilities

Securities regulation in the U. S. is to a large degree based upon self-regulation. The major U. S. exchanges, which had exercised control over their members and listed companies even before the advent of Federal regulation in 1934, are part of an integrated system in which day-to-day regulation is for the most part their legal responsibility, and direct Government intervention is only exercised as a last resort - or, in the words of former S.E.C. Chairman (now Justice) William O. Douglas, "Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready to use but with the hope it would never have to be used." <sup>1/</sup> In the U.S. over-the-counter market, the National Association of Securities Dealers plays a self-regulatory role similar to that of the exchanges.

A self-regulatory system has several advantages over one in which reliance for regulation is placed solely on the Government. First, self-regulation can be broader in scope. The securities industry can insist that its members follow ethical concepts of fair dealing while the Government is restricted to enforcing

---

<sup>1/</sup> Douglas, Democracy and Finance (1940)82.

legal requirements. Secondly, businessmen can bring more expertise and understanding to regulatory problems affecting their business than can a Government agency. Thirdly, there is an advantage in involving members of the industry in such questions; as a consequence they will be more likely to exercise self-discipline over their own actions. Finally, self-regulation reduces the expense and administrative burden that is placed upon the Government.

The two major Brazilian stock exchanges are not at the present time self-regulatory bodies in any sense of the word. Each is governed by a small committee of active members, and neither has any staff with responsibilities for surveillance or regulation of members' activities. The Rio exchange has not disciplined a member for any reason during the past 45 years. In general, it does not appear that the present administration of either exchange has much interest in or aptitude for self-regulation, even where instances of wrongdoing are brought to its attention.

The Capital Markets Law seems to contemplate that the exchanges will act as self-regulators, at least in enforcing rules formulated by the Government. Article 7 provides that the National Monetary Council will fix the rules of the exchanges in the areas of exchange organization, disciplining of members, number of members and qualifications for admission, types of operations and methods of operating, financial administration, commissions and other charges, manipulation and fraud, price-maintenance operations, books and records to be maintained by the exchange and by members, collection of statistical data, controls over listed companies, and margin requirements.

A potential self-regulatory force that should not be overlooked is ADECIF, an association of approximately 50 investment, credit, and finance companies, some of which are active in underwriting and other aspects of the securities business. The association is composed principally of Rio de Janeiro firms, but it now has a few members in other cities, and it hopes to become a truly national organization. Thus far, ADECIF has largely concentrated on lobbying activities in connection with legislation affecting its members. The members of ADECIF apparently recognize that it is in their interest to help shape the changes that are taking place in the Brazilian securities industry. If these firms become stock exchange members, they may be able to get the exchanges actively involved as a partner, so to speak, of the Government in rebuilding the securities markets and providing for effective regulation of them. On the other hand, ADECIF could provide the nucleus of a separate self-regulatory organization in the over-the-counter market, similar to the National Association of Securities Dealers in the U. S.

Although the basic sense of responsibility, support, and financing for any self-regulatory system must come from persons active in the industry, these persons are unlikely to have the time or the skills that are needed for the effective operation of such a system. In the U. S., the NASD and all but the most unimportant exchanges have a full-time, paid professional administrator as president. <sup>1/</sup> The Constitution of the New York Stock Exchange states:

---

<sup>1/</sup> The New York, American, Midwest, Pacific Coast, Philadelphia-Baltimore-Washington, and Boston Stock Exchanges have paid presidents.

"The President shall be the chief officer and the chief executive officer of the Exchange, responsible for the management and administration of its affairs, and shall be the official representative of the Exchange in all public matters. By his acceptance of the office of President he shall be deemed to have agreed to uphold the Constitution of the Exchange. He shall, during his incumbency, be a member of the Board of Governors and ex officio a member of any committee authorized by the Board of Governors." 1/

We would recommend that the Rio and Sao Paulo exchanges create the full-time position of president and give him similar authority and responsibility. The president should have a contract with the exchange in order to ensure his independence. He should have at his disposal sufficient funds to employ a staff to run the exchange's business and adequately regulate its members. The regulatory staff, which should be responsible to the president and not to the members of the exchange, need not be large. Four or five persons of professional caliber would probably be enough at least at the beginning.

(b) Regulation by the Government

Whether or not the securities industry has a significant part in regulating the Brazilian markets, the role that is played by the Government itself is vital. The Capital Markets Law gives the National Monetary Council and the Central Bank broad powers to act in a number of areas. Many of these powers cannot or should not be delegated to the exchanges or any other self-regulatory body. Even where industry is allowed to regulate itself, the Government should provide active oversight of the self-regulators and should be ready

---

1/ Article VI, Sec. 1.

and able to take direct action if the self-regulators fail to do their job. Furthermore, the Government can perform an important role in guiding and assisting the Brazilian securities industry in effecting necessary changes in the markets. This seems to be contemplated by the Capital Markets Law, which provides for financial support by the Government for the reorganization of the stock exchanges. For these reasons, it is important to inquire whether the Government is equipped to handle its responsibilities for regulation of the securities markets.

Before the adoption of the Capital Markets Law there was virtually no Government regulation of the securities markets. Under Instruction No. 309, issued in 1959, the Ministry of Finance laid down certain rules to be followed by investment, credit, and finance companies; this regulation, however, was chiefly concerned with the financial responsibility of these institutions, and it seems to have been viewed as an adjunct to the banking laws. Responsibility for enforcement of Instruction No. 309 was given to the Superintendant of Currency and Credit (SUMOC), of which the Central Bank of Brazil is the successor.

The Capital Markets Law designates the Central Bank as the Government agency charged with its administration and enforcement. We heard some criticism of this decision by persons who thought that it would have been better to have established a new agency to handle securities regulation, chiefly owing to certain legal restrictions on the Central Bank that make it difficult for it to hire qualified persons.

At present the staff of Brazil's "S.E.C." appears to consist of one individual, much of whose time is occupied with examining prospectuses of new issues of securities -- one of the new responsibilities of the Government under the Capital Markets Law. The major questions of reorganizing the markets and devising a system of regulation are being considered by a

small committee, whose members include the president of the Central Bank, two other Central Bank officials, and two persons in the securities business. With the single exception of the official referred to above, all of these persons have demanding jobs elsewhere that require most of their time and energy.

We cannot judge the wisdom of the decision to give the Central Bank the authority to regulate securities matters. We believe, however, that little can be accomplished in implementing the Capital Markets Law until the Government creates an adequate staff of competent professionals who can devote their full-time energies to this task. Such a staff would not have to be large. As a beginning, three or four persons capable of operating on a policy-making level, and perhaps a dozen others of professional caliber, preferably with specialized training (e.g. accounting) or experience in administrative work or in the securities business, would be adequate.

In January 1966 30 young Brazilians will go to the United States for a training program in securities matters, including six months of study at New York University Graduate School of Business Administration, to be followed by three months of "internship" on Wall Street or in Washington. This project is sponsored jointly by AID and the Brazilian National Development Bank. We understand that approximately five of these persons will work for the Central Bank upon their return to Brazil. This program will undoubtedly be of important value in the long-run development of the Brazilian securities markets, especially if it is combined with, and foreshadowed by, the immediate creation of a regulatory staff in the Central Bank.

(c) The Role of AID

One of the purposes of the visit upon which this report is based was to determine whether further technical assistance by AID would be advisable. In the course of the visit, the president of the Central Bank orally requested that the authors, or if they were not available others with similar fields of specialization, return for a period of six months.

We think that further assistance would be desirable in a number of areas, principally to help in implementing the recommendations made in this report, including the training of a regulatory staff both in the Government and the exchanges, and the drafting of regulations under the Capital Markets Law.

We have serious reservations, however, as to the usefulness of providing technical assistance of this kind until the Government has taken the necessary steps to staff itself that are referred to in the previous subsection of this report. The areas in which implementation is required are extremely broad, and a great deal of hard work will have to be done if even a small part of it is to be completed within six months. It would be hopeless to try to accomplish this task unless the specialists providing the assistance can work closely with senior Brazilian officials who give their full time to it and who have the necessary authority to act.

We think that it also may become advisable at some time in the future for persons with certain specialized backgrounds to give short-term assistance. For example, if a dealer system is inaugurated on the major stock exchanges, a specialist from one of the American exchanges might be able to provide practical advice and help to the Brazilian exchanges and their members. It is possible that a visit of no more than one or two weeks would be necessary for this purpose.

(d) Recommendations

I The major stock exchanges should organize themselves as self-regulatory organizations, with a full-time paid administrator as president and an adequate regulatory staff.

II For the purpose of providing oversight over the self-regulatory activities of the exchanges as well as direct regulating controls in certain areas, the Government of Brazil should build an adequate staff of professional employees. Such a staff might at the beginning consist of three or four persons capable of working on a policy-making level and perhaps a dozen others, preferably with relevant specialized training or experience.

III We would recommend that further technical assistance be provided for a period of approximately six months for the purpose of implementing the Capital Markets Law and the recommendations of this report. We do not believe, however that such assistance would be useful until the Government of Brazil has taken steps to build an adequate staff.

## 7. Conclusion

This report contains recommendations designed to strengthen and broaden the Brazilian stock markets in a number of specific areas where improvements can be made, including the trading markets, the securities industry, and corporate disclosures. From these recommendations, a few basic points emerge.

First, the Brazilian stock markets have clearly outgrown the institutional structure under which they have been functioning. Although this structure may have been ideally suited for the markets of the 1890's, it appears to be inhibiting the growth of today's markets. The recommendations contained in this report are aimed at removing outmoded restrictions on the development of the markets. Thus we recommend that membership of the stock exchanges be opened to all qualified firms and that the present system of trading be replaced by a continuous auction market under which stocks can be traded throughout the trading session.

Secondly, Brazil has the elements of a strong securities industry capable of acting as intermediary between industrial companies and the investing public. The efforts of the Government to encourage firms that have heretofore concentrated their activities to the exchange bill business to turn their efforts (and capital) to the "share business" should be continued. Moreover, it is hoped that the securities industry will recognize that it is in its own interest to work as an active partner of the Government in regulating the market place. To the extent possible, the Government should encourage self-regulation.

Thirdly, every effort should be made to increase the public's confidence in the securities markets. This is a long-range goal which can be accomplished only by providing a solid basis for such confidence. Brokers should be encouraged to provide adequate services to their customers and, above all, provision should be made for full disclosure by companies seeking public financing or whose securities are publicly held, of matters likely to affect investment decisions. We believe that improvement in disclosures will help bring about the desired broad public participation in the securities markets.

Finally, it would be unrealistic to expect that these recommendations can be implemented until the Government establishes an adequate staff that can fully devote its energies to these problems and can guide the securities industry through the program here outlined. If such a staff is established, AID-sponsored technical assistance for a period of approximately six months would be valuable for the purpose of training staff members and implementing the recommendations contained in this report.