GOVERNANCE OF BRAZILIAN PENSION FUNDS

By

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ABSTRACT

This paper analyzes theoretically and empirically the governance of pension funds in Brazil. It first demonstrates that the law allows sponsors (employers) to write contracts (by-laws) governing the relationships between the sponsors, the managers and the participants (employees) of the pension funds. It also explains that, from an agency theory perspective, this legal framework favors non-optimal governance structures, since sponsors do not bear the financial consequences of the contracts they create. As predicted, the empirical evidence reported in this thesis shows that sponsors use this authority to create contracts that minimize monitoring and maximize control over business decisions to the greatest extent permitted by law. For instance, the findings show that, in writing the by-laws of pension funds, sponsors reduce the functions of management bodies in which participants have seats. Moreover, there is evidence that the by-laws contain extra requirements for the members of administrative bodies in order to ensure that the individuals elected to these bodies have a contractual or fiduciary relationship with the sponsor, and therefore, are within the sponsor's sphere of influence. The paper concludes by identifying some of the areas in which empirical assessment is necessary for the recommendation of reforms in the complementary social security system in Brazil.

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INTRODUCTION

Social security systems are undergoing major changes in several countries, including perhaps the United States. The discussion on policy choices and efficient structures regarding each of these reforms is not limited to specialized scholarship. Not surprisingly for an issue of this magnitude, this discussion is addressed almost every day by all sorts of media, the most respected newspapers, politicians, non-governmental organizations, trade unions, financial markets players and others. Tensions arise because the interests of each of these groups differ.

Government concerns regarding its social security system are related to social welfare and security. On the one hand, they should want a system that works and can guarantee their citizens protection after retirement; otherwise social security will not be achieved. On the other hand, they may not want to bear the risks of a pay-as-you-go system financed with payroll taxes that offers defined benefit plans, as was the typical structure of social security system in most of the countries that had a welfare state at some point in the past.

The financial market players' concerns relate to how this huge amount of money will be managed and invested in a wide variety of assets. How speculative, how conservative or how activity the managers that control such resources will be is a crucial question. The monitoring of the market by institutional investors is identified as one of the most promising alternatives for disciplining management; therefore a common discussion in corporate law is the role of the institutional investor in shareholder activism. Pension funds are considered the most important institutional investors. Hence any decision that affects their structure, especially their governance, may cause changes in the entire financial system.[1]

Of course, any citizen is interested in the subject because the social security system usually provides the resources for living after retirement. Worldwide employers have been facing the debate curiously, particularly after the Enron scandals. When Enron failed, its workers lost not only their jobs but also their retirement savings, since over 60% of Enron employees pension funds assets were invested in its stock.[2] The Bush administration and some members of the American Congress have been promoting the privatization of social security system as a way of taking pressure off it. In response to the Bush administration efforts, important civil organizations have been bringing the debate to the workers. For instance, AARP, the lobbying organization for older Americans that opposes President Bush's Social Security proposal, ran $5 million in print advertisements for a campaign against Bush's privatization bill.

An important component in any effectively administered social security system is a governance structure that properly supervises and incentivizes its administrators. This is particularly true with regards to pension funds within such a system. Pension funds manage enormous pools of capital with the stated objective of providing adequate retirement benefits for fund participants. Whether this capital is faithfully and efficiently deployed will depend in large part on the incentives of the managers of the capital. In the case of the pension funds, incentives are intimately tied to the allocation of risks and to

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[1] *See* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered* 93 COLUM. L. REV. 795, 795-796 (1993).
[2] *See* Timolthy Besley & Andrea Prat, *Pension Fund Governance and Choice between Defined Benefit and Defined Contribution Plans,* 13 (CEPR, Discussion Paper No. 3955, 2003), *available at* http://ssrn.com/abstract=436991.

the degree to which the funds are administered as defined contribution or defined benefit plans.

In Brazilian pension funds, decision makers are generally under the pressure of the sponsor's management and controller, which may be a private corporation or a state controlled corporation. Neither sponsors nor management of pension funds bear the wealth consequences of their decisions, and therefore they have weak incentives to maximize the value of pension assets. Even worse, there is evidence that pension funds have been used to the satisfaction of sponsors' desires both in the private and public sectors.

This paper documents and analyses under agency theory the governance structures of the existing pension funds in Brazil through an empirical research on the by-laws of 30 of these entities. It is focused on the organizational structure and on the incentive system facing their investment decision makers. Brazilian law stipulates a basic three-tier internal governance structure and a few requirements of the members of each tier. Other than this statutory outline, the governance mechanisms of individual funds are largely discretionary and are determined by the particular provisions of the fund's by-laws. Those by-laws, in turn, are generally drafted by the fund sponsors, subject to the nominal constraint of approval by regulators. This paper explores what the drafters of by-laws (sponsors/employers) include in the by-laws, why they choose to include it, and the consequences of these choices on the governance of Brazilian pension funds.

The core contribution of this paper is to demonstrate, theoretically and empirically, the weakness of the governance of Brazilian complementary social security system. This is a particularly important issue now due to the recent pension reforms. As a result of these reforms, explained in Part I below, new pension funds will be created in molds very similar to ones that comprise the sample of this empirical research. It will be useful for the workers in both the private and public sectors to think about a way to strengthen the current legal framework.

While the analysis presented in this paper is in many ways very simple, it is a first step towards identifying challenging theoretical questions and suggesting directions for future research and policy debate in Brazil on a very relevant issue, about which scholarly analysis is still scarce.

This paper is organized into three parts. Part I describes the Brazilian social security system and analyzes the legal and institutional framework regulating *entidades fechadas de previdencia privada* (EFPCs), the organizational form of the Brazilian pension funds.

Part II reviews the concepts of agency theory and discusses how they can be used to analyze the Brazilian regulatory scenario. The theoretical tools offered by agency theory will be helpful in two ways. First, they will help identify the weakness of the organizational structure of the Brazilian pension funds market. Second, they will help determine the appropriate governance structure for pension funds. Part II also presents the hypothesis of how sponsors draft by-laws of pension funds by predicting, from a theoretical standpoint, how agents will react to the Brazilian regulatory scenario.

Part III describes the methodology used to conduct the empirical study, as well as the findings of the study. Relevant data collected in the empirical investigation is found in Appendices I and II. Part III also contains an analysis of the findings and cooperation between the predictions stated in Part II and the findings of the empirical research.

Finally, the conclusion will summarize results and explain policy implications.

1. BRAZILIAN SOCIAL SECURITY SYSTEM

1.1 The Tripartite Structure of the Brazilian Social Security System

The social security system in Brazil is comprised of three wholly separate and independent systems: (1) a basic general system managed by a body of the federal government; (2) a special system for public employees currently administered by dispersed governmental units—today the federal government, each state and each county has its own administrator of public sector pensions—but that recent legal reform has moved to centralize; and (3) a complementary system of pension plans provided by private entities. Under Brazilian law, complementary system pension plans are provided by financial institutions, by special entities (pension funds) created to provide retirement plans, and by certain other entities authorized by competent authorities.[3]

Although the basic tripartite structure of Brazil's social security system remains, the social security system has recently experienced several major changes. The legal instruments of these reforms include constitutional amendments (Amendments 20 and 41 to the Federal Constitution, dated respectively December 15, 1998, and December 19, 2003) as well as a whole new set of infra-constitutional statutes and other regulations.

1.1.1 General System

The general system—a pay-as-you-go system, financed by payroll taxes—is the most important part of this tripartite structure. This system is mandatory for all private-

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[3] MINISTÉRIO DA PREVIDENCIA SOCIAL, PANORAMA DA PREVIDENCIA SOCIAL BRASILEIRA 11 (2004), *available at* http://www.previdenciasocial.gov.br/docs/panoramaPS.pdf.

sector workers and is managed by the National Institute of Social Security (*Instituto Nacional de Seguridade Social* or INSS), a governmental entity. The system provides two kinds of benefits: a social assistance benefit, and a length-of-service benefit. The social assistance benefit is granted to those individuals who do not contribute to the system or who contribute for a period shorter than the minimum amount of time necessary to earn the right to the length-of-service benefit. These individuals, such as pregnant women, senior citizens, and the disabled, do not have to contribute to the social security system but will receive benefits.[4] The length-of-service benefit requires individuals to contribute at a rate set by Brazilian law, depending on one's wage level. Individuals' contributions are limited to the amount that will ensure the beneficiary a retirement benefit equal to R$2,400.00 (equivalent to approximately US$900.00).[5] If one desires a benefit greater than this amount, the individual must use the private complementary system.

1.1.2 Special System for Public Employees

The second part of the tripartite structure, the part most affected by the aforementioned reforms, is the special system for public employees. Similar to the general system, this is a mandatory pay-as-you-go system financed by payroll taxes paid by the employers and workers of the public sector. Prior to the reforms, there was no limit on the amount that public employees could contribute to and therefore benefit from the system. As a general rule, the contribution was proportional to an individual's current wage and the benefit equal to the last active wage. Therefore, workers' benefit was not

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[4] *See* André Portela Souza et al., *Fiscal Impacts of Social Security Reform in Brazil* (2004), *available at* http://www.anpec.org.br/encontro2004/artigos/A04A138.pdf.
[5] MINISTÉRIO DA PREVIDENCIA SOCIAL, *supra* note 3, at 30.

necessarily proportional to the contributions of the worker during his work-life. The reforms involve a number of changes such as setting a minimum age, changing the method of calculation of the benefit, readjustment rules, and others.

Most importantly, however, the reforms enable the government at all levels (Federal, State, and Municipal) to subject new public employees[6] to the same limits on their contributions and benefits to which private employees are subject.[7] If the government chooses to do this, they must also establish a complementary system so that employees have the option to have a private entity match their contributions, thus enabling them to surpass the limit of payout set by the government.[8] This complementary system shall be implemented through a specific form of pension funds called *Entidades Fechadas de Previdência Complementar* ("EFPCs"), better known in Brazil as pension funds, and addressed in Section 1.1.3 below.

These to-be-created EFPCs must be sponsored by public entities and must offer to its participants exclusively-defined contribution plans[9] through the general system and through the special system for public employees, as opposed to the defined benefit currently offered by the government.[10] It is also important to note that the Federal Constitution prohibits the government and all public companies from transferring funds to such pension funds, except for the ordinary contributions made as sponsors.

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[6] The public employees hired before the implementation of the relevant complementary system can be subject to the new system only upon previous and express agreement (Constituição Federal [C.F.] [Constitution] art. 40, §16, *amended by* Constituição Federal [C.F.] amend. 20).
[7] Constituição Federal [C.F.] [Constitution] art. 40, §14, *amended by* Constituição Federal [C.F.] amend. 20.
[8] *Id*.
[9] Constituição Federal [C.F.] [Constitution] art. 40, §15, *amended by* Constituição Federal [C.F.] amend. 41.
[10] The trend of a shift from defined benefit to defined contribution pension plans is not only a Brazilian phenomenon. In the U.S., contributions to defined benefit plans amounted to 18% of the total contributions in 1985 and today they amount to 80% of the total contributions. See Timolthy Besley & Andrea Prat, *supra* note 2, at 2-4.

Furthermore, contributions made by the government and public companies as sponsors may not be higher than the contribution made by the participant of the plan.[11]

When implemented, these reforms will transfer a large amount of wealth to the management of the new pension funds. The government predicts that these reforms can increase pension savings by 50% by 2008.[12] It also appears as though these pension funds will be created soon, as the *Secretaria de Previdencia Complementar*, the federal executive branch department responsible for the government's interaction with the pension funds, included the implementation of this new system as one of its four main goals for the years of 2004 and 2005.

1.1.3 Complementary System

Finally, the third part of the tripartite structure of the Brazilian social security system is the private and voluntary complementary system. The complementary system is made up of *Entidades Abertas de Previdência Privada* ("EAPCs") and *Entidades Fechadas de Previdência Complementar* ("EFPCs"). EAPCs, include any financial institution authorized by the government to offer individual pension plans as a service to either a person or to a company. When employers and employees enter into such a pension plan, they are essentially buying a financial service as they will have no say in the investment decisions or other issues. The Brazilian Central Bank (*Banco Central do Brasil*) and the National Monetary Committee (*Conselho Monetário Nacional*) regulate the EAPCs and the Superintendent for Private Insurance (*Superintendência de Seguros Privados*) monitors them.

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[11] Constituição Federal [C.F.] [Constitution] art. 202, §3, *amended by* Constituição Federal [C.F.] amend. 20.

[12] MINISTÉRIO DA PREVIDENCIA SOCIAL, *supra* note 3, 49.

EFPCs are created by an employer or group of employers as formally independent foundations or non-profit limited liability partnerships.[13] The sole purpose of EFPCs is to manage the funds of their participants. Formally, the employees and employers are jointly responsible for deciding and monitoring the way in which the pension assets are managed—as it will be showed later, this paper claims that in practice workers have very little role in deciding and monitoring the management of pension assets.

EFPCs are currently responsible for 90% of the Brazilian social security complementary system,[14] a percentage that has grown rapidly over the last few years. In the last 8 years, the total amount of assets in EFPCs has increased from R$72 billions to R$231 billions.[15,16] Furthermore, the rate of growth has accelerated. Between December 2001 and December 2002, the total value of assets in EFPCs increased about 11%,[17] while between December 2002 and December 2003, the value increased by 26.9%. This impressive expansion has increased the importance of pension funds within the national economy. By December 2003, the total value of assets in EFPCs was equal to 18.2% of the GDP.[18] In addition, the Federal Constitution designated EFPCs as the form of entity to be implemented under the complementary system for new public employees, as

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[13] Since 2001, the law also authorizes professional or labor associations (as trade unions) to create and manage pension funds. However, very few have been created so far— only 4 such pension funds had been created as of December 2003. When created by professional or labor associations, pension funds should delegate the managements of their assets to a specialized entity authorized to operate by the Brazilian Central Bank. Since their managers will not be responsible for investment decisions, even when these pension funds are created they will not be relevant for this paper.
[14] MINISTÉRIO DA PREVIDENCIA SOCIAL, *supra* note 3, 48.
[15] SECRETARIA DE PREVIDENCIA COMPLEMENTAR, INFORME ESTATISTICO (July 2004), *available at* http://www.previdenciasocial.gov.br/12.asp.
[16] These values do not take into consideration inflation, which, according to the official index of the government (IPC-A), was close to 80% for the period, and, according to the most widely used index for readjustment of agreements in Brazil, was close to 145% for the period.
[17] Before that, the growth of pension-fund financial assets in relation to GDP increased between 1980 and 1997: 1% (1980); 3% (1990); 11% (1997). *At* http://www.ocde.org/.
[18] LCV News, *News about Corporate Governance – January-February/2004*, *available at* http://www.lcvco.com.br/english/lcvnews.htm.

explained in Section 1.1.2 above.

Because of the great importance of EFPCs, this paper will focus exclusively on the governance of EFPCs.

1.2 Governance of Pension Funds (EFPCs) Under Brazilian Law

As mentioned above, the current Brazilian EFPCs are created and sponsored by a corporation or a group of corporations, and, therefore, they are all technically created by a private entity.[19] However, Brazilian regulation categorizes the EFPCs into two different groups: privately-sponsored pension funds and publicly sponsored pension funds.[20] This categorization is determined, not by who actually created and sponsored the fund, but by who has effective control of the sponsor. If the corporate control of the sponsor is held by a private party, then the pension fund is considered to be privately-sponsored. If the effective control of the sponsor is held by a public entity or an entity controlled by a public entity, the pension fund is considered to be publicly-sponsored. This categorization is important because Brazilian pension funds are subject to different rules of governance depending on their being considered as either privately-sponsored or publicly-sponsored.

The governance of pension funds sponsored by private entities is established by section 35, chapter III of *Lei Complementar no. 109*[21] and the governance of pension funds sponsored by public entities is established by section 9, chapter III of *Lei Complementar no. 108*.[22] Both statutes set forth a mandatory three tier structure

[19] The recent reforms authorize unions to create pension funds but none have been created so far.
[20] Lei Complementar No. 109, de 29 de Maio de 2001, D.O.U. de 30.05.2001, Capítulo III, art. 31.
[21] *Id*. art. 35.
[22] Lei Complementar No. 108, de 29 de Maio de 2001, D.O.U. de 30.05.2001, Capítulo III, art. 9.

including: (1) a *conselho deliberativo* (a deliberative council); (2) a *diretoria executiva* (executive officers); and (3) a *conselho fiscal* (a fiscal council). The first two bodies have managerial functions, while the third one has a monitoring function.

The functions and responsibilities of the deliberative council and the executive officers, as well as the division of power between them are unclear. With regards to the pension funds sponsored by private entities, there is no rule providing parameters for these bodies' functions, therefore the by-laws of the pension funds sponsored by private corporations have to establish all the functions and powers of these bodies.

Pension funds sponsored by public entities, however, have the functions of these bodies establishes by *Lei Complementar no. 108*. The deliberative council has competence to decide on the following matters: (1) general management policy of the pension fund and of each of its individual plans[23]; (2) amendment of the pension fund's by-laws and amendments to the rules of each of the individual pension plans; (3) the creation or extinction of a pension plan; (4) withdraw of one of the pension's sponsors (in case there are more than one); (5) policy of the investment management and plan of investment; (6) approval of a investment when it amounts more than 5% of the pension guarantor assets[24]; (7) hiring outside auditing companies; (8) election and dismissal of the executive officers; (9) examining, in an appeal level, the decisions of the executive officers. By statute, the executive officers of pension funds sponsored by public entities

[23] One single pension fund may have more than one pension plan with different characteristics, terms and conditions.

[24] 'Guarantor assets' is an account term defined by law that means all the assets of the investment program, plus cash and equivalents, minus operational payable accounts. *See* Resolução CMN No. 3.121, de 25 de setembro de 2003, D.O.U. de 26.09.2003, Anexo I, art. 1, § 1º. "Para efeito deste regulamento, consideram-se recursos garantidores dos planos de benefícios administrados pela entidade os ativos do programa de investimentos, adicionadas as disponibilidades e deduzidos os valores a pagar, classificados no exigível operacional do referido programa."

should carry out the day-to-day affairs of the entity subject to policy approved by the deliberative council.[25] [26]

There are two requirements pertaining to the composition of privately-sponsored pension funds. First, the by laws of such pension funds must demand that at least one third of the deliberative counsel and one third of the fiscal counsel are composed by workers that are part of the fund. Second, the individuals to be appointed to the deliberative and fiscal councils must meet the following requirements: (1) they must have previously participated in financial, management or accounting activities; (2) they must not have been convicted of any crime; and (3) they must not have been convicted in any administrative process for violation of the regulations set by the social security system or for any other infractions as a public employee. In addition to the requirements made of members of the deliberative and fiscal council, a graduate degree (in any discipline) is required of executive officers.

Publicly-sponsored pension funds are faced with a more detailed set of governance rules. First, the members of the deliberative council are non-removable such that they can only be dismissed from their office by resignation, judicial conviction for criminal conduct, or by an administrative disciplinary process.

Second, requirements pertaining to the composition of the deliberative council are more stringent. The statute states that the deliberative council shall be composed of up to six members, three of whom must be appointed by the workers and three of whom may

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[25] *Supra* 22, art. 19.

[26] It is unclear whether by-laws could change these competences. In the Brazilian system there are some legal rules that can be changed by the agreement among private parties and others that cannot. When the legislator wants to make clear that the rule can be modified by contract, s/he often uses the expression "unless otherwise agreed by the parties" before the relevant rule; on the other hand, when the legislator wishes to ensure that a provision will not be changed by private parties, s/he often uses expressions as "this matter is to be exclusively decided by" or "unless otherwise established by law". The ambiguity happens when the statute does not explicit express whether the norm is modifiable or not.

be appointed by the sponsor. All members have a four-year term in office. Regardless of the balance in the number of members, the public sponsor of pension fund appoints the president of the deliberative council and the president's vote prevails in the event of an impasse.

The legal requirements for the individuals appointed to the management (deliberative council and executive officers) and monitoring bodies (fiscal council) of publicly-sponsored pension funds are similar to those for the individuals appointed to these bodies of privately-sponsored funds. First, they must have previously participated in financial, management or accounting activities. Second, they must not have been convicted of any crime. Third, they must not have been convicted in any administrative process for violation of the regulations set by the social security system or for any other infractions as a public employee.

Apart from the rules described above that are set forth in *Lei Complementar no. 108* and *Lei Complementar no. 109*, a fund's by-laws establish the vast majority of the fund's governance regulations. The by-laws are generally drafted, enacted and modified by the sponsors of the funds which gives the sponsors leverage over the decision-making process of these funds, particularly investment decisions.

1.3 Insolvency Rules for Pension Funds

Insolvency rules applicable to pension funds might not be directly related to governance structure; however, for the purposes of analyzing the governance structure of the Brazilian pension funds under an agency theory perspective, it is important to know who bears the risk of insolvency of these entities.

In the event that the assets of the pension fund are not sufficient to meet its obligations, the competent governmental authority, the Complementary Pension System Secretariat (*Secretaria de Previdência Complementar*), can intervene in pension fund administration by dismissing all the managers and appointing a custodian to manage the fund. This custodian will manage the fund as long as it is necessary to evaluate the financial conditions of the plan and draft a recuperation plan.[27] The recuperation plan can recommend certain business measures in order to recover the financial vigor of the entity, or call for a liquidation procedure of the fund, called "extrajudicial liquidation." Under extrajudicial liquidation, fund participants receive elevated priority—the same protection furnished under Brazilian law to tax authorities and employee creditors—with regard to the assets of certain account reserves. In relation to all other fund assets, fund participants are in the same position of any other creditor.

Fund sponsors and fund managers are generally not liable for deficiencies. Fund managers can be made responsible for a deficiency only if the insolvency resulted from unlawful acts committed by them. Fund sponsors can be made responsible for a deficiency if the insolvency was caused by a failure to make their complete required contributions to the fund or if it resulted from unlawful acts by them.

There is no legal obligation for pension funds to obtain insurance. Therefore, it is not an exaggeration to say that fund participants ultimately bear the risk of insolvency of Brazilian pension funds. And, the risk of participants (employees) here is to lose all the retirement complementary savings if the pension fund fails.

For the sake of comparison, the U.S. rules for defined benefit plans under insolvency are worth mentioning here. In the event that the assets of the fund are not

[27] *Supra* note 20, art. 44, 45 and 46.

sufficient to meet the pension obligations, sponsoring employer is obligated to supply the deficiency.[28] Insolvency of the firm, however, will result in the inability to cover the deficiency. In this event, there is an insurance provided by the Pension Benefit Guaranty Corporation.[29] Employers pay plan termination insurance premiums to this entity, which in turn guarantees pension benefits up to a maximum set by law and adjusted yearly.[30] For plans ended in 2005, workers who retire at age 65 can receive up to $3,801.14 a month.[31]

The fact that in Brazil the design of the structure that will produce the management and investment decisions is on the hands of the sponsor, and the risks of these decisions are borne by the workers suggest that serious problems exist in the governance structure of these funds, since the sponsor will not bear the consequences of the decisions s/he will control.

1.4 Evidence of Problems in the Governance of Brazilian Pension Funds

Although a theoretical analysis of the legal framework described in Sections 1.2 and 1.3 above may identify many weaknesses in the governance rules and structure of the governance of the pension funds in Brazil (see Part II), these rules—particularly with regard to the complementary system—actually represent an effort to build a more stable Brazilian social security system in the face of government pension fund scandals.

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[28] Employment Retirement Income Security Act of 1974 (ERISA), § 3(35), 29 U.S.C. § 1002(35) (1982).
[29] Pension Benefit Guaranty Corporation is a federal government corporation established by ERISA. id., to encourage the continuation and maintenance of voluntary private pension plans. It is headed by an Executive Director who reports to a Board of Directors consisting of the Secretaries of Labor, Commerce and Treasury, with the Secretary of Labor as Chairman. See http://www.pbgc.gov/laws/default.htm.
[30] Bill Shaw, Moshe Hagigi & W. Clifford Atherton, Jr., *Investment Prudence and Fiduciary Responsibility in Managing Defined Benefit Pension Funds Under ERISA*, 22 Suffolk U. L. Rev. 83, 84-85 (1988).
[31] The guarantee is lower for those who retire early or when there is a benefit for a survivor. The guarantee is increased for those who retire after age 65.

Brazil is not a unique case. Governance regulation of pension funds has not always existed in other countries. As in Brazil, it has generally been introduced as a response to cases of fraud or misappropriation of pension assets. Two examples can be mentioned: the United Kingdom and the United States.[32] The fiduciary standards introduced by the Employee Retirement Income Security Act (ERISA) of 1974 in the United States were largely in response to cases of fraud in pension fund management and of plan insolvency caused by the bankruptcy of the plan sponsor. Similarly, in the United Kingdom, the decision to enhance the responsibility of trustees over pension fund management and to increase their independence in relation to pension fund sponsors was primarily a response to the Maxwell scandal.[33]

The previous regulations[34] did not include any provisions regarding the governance of pension funds. Furthermore, the limited regulations regarding the management of these entities were quite surprising. One provision, for example, allowed the managers of the pension funds to be the same as the managers of the sponsors, as long as the assets of the fund and the sponsor were separate.[35] This structure obviously does not prevent agency problems between sponsors, participants and managers but rather enables such problems. In part as a result of such flawed regulation, Brazil has experienced various pension fund scandals, many of which have yet to be resolved. This Section describes some of these problems, which together with the theoretical analysis and findings of the empirical research, point to the weaknesses of the current regulation

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[32] Those examples were taken from JUAN YERMO & ANNAMARIA MAROSSY, INSURANCE AND PRIVATE PENSIONS COMPENDIUM FOR EMERGING ECONOMIES (2001) *available at* www.oecd.org/daf/insurance-pension.
[33] The Maxwell companies' main pension fund lost a large percentage of its assets as a result of lending to and investing in insolvent companies linked to Robert Maxwell.
[34] Lei No. 6.435, de 15 de Julho de 1977, *amended by* Lei No. 6.462.
[35] *Id*. art. 50.

of the governance of pension funds. The following three examples are illustrative of the inadequacy of the current governance structure.

First, the frequent actuarial inadequacy of the funds' investments highlights the flaws of pension fund governance. While there is no official data available on this issue, of the given sub-sample of 15 privately-sponsored pension funds, only seven[36] disclose actuarial expertise information on their website. Among these seven entities, four had an actuarial deficit, which means they either made poor investment decisions or used poor funding strategies. Three had adequate actuarial results.

This data is relevant for two reasons. First, it points to a lack of transparency by the pension funds, notwithstanding the legal requirements. Pension funds have very few disclosure obligations in relation to governmental authorities and even less with regards to their participants. Every pension fund must annually prepare financial statements and carry out actuarial analysis and then file the resultant documents with the competent governmental authority and disclose them to participants.[37] The law does not provide any details as to the means which pension funds should use to file this documentation or disclosure such information to the participants. Also the law[38] requires the funds to inform the participants about their individual plans and benefits once a year, however it does not provide any details as to the means of notification and about what exactly the funds should inform the participants. The participants may also have access to information upon request in order to defend or understand their rights, but the procedures for accessing this information are not clear.

The fact that pension funds do not disclose actuarial expertise information on their

[36] *Fundação Itaubanco, BANESPREV, Elos, Telos, Fundação A. F. Xavier Fontana, Sistel,* and *Aerus*.
[37] *Supra* note 20art. 22.
[38] *Supra* note 20art. 24.

websites is shocking because it shows that the pension funds do not volunteer much information, unless they feel firmly obligated by law to do so even when the costs for doing are as low as upload a document and make it available on their website.

Second, since four out of the seven entities examined showed actuarial deficits, this data indicates that a substantial number of the pension funds have inadequate investing or funding practices. This lack of transparency and poor management decisions suggest that serious problems exist in the governance structure of these funds.

The second piece of evidence that indicates that there is a weak governance structure is the frequent existence of debt owed by sponsors to the pension funds. As a general rule, a pension plan is funded by contributions from employees and proportional contributions of these employees' sponsors (equal or lower than the contribution of the employee), in accordance with the specific plan rules. However, it is fairly common when facing financial constraints for these sponsors to stop making their contribution without justification and negotiate the payment with the pension fund management afterwards. Although precise information on the total amount that sponsors owe to pension funds is not publicly available, the fact that a resolution was passed,[39] that set forth the rules for the negotiation of debt-service plans, indicates that such a situation was frequent enough to necessitate a regulation. In addition, when sponsors implement a plan to pay off their debt, pension funds often seek to create the impression that they are doing an act of good service when, in reality, they are just remedying a prior irresponsible act.

The third example is the scandals involving Previ, the pension fund for the employees of a Banco do Brasil (a state-controlled financial institution), which is the largest in Brazil and controls assets valued at approximately 25 billon dollars (see

[39] Resolution CGPC No. 17, 11 de julho de 1996.

Appendix II). As all other pension funds, and as required by its by-laws, Previ was supposed to be a private and independent entity[40]. However, since the government controls Previ's sponsor, Banco do Brasil, some argue that the federal government had (and may still have) immense power over Previ's investment decisions. As a result, many believe that Previ's resources were used to finance sectors that the government deemed important for the national economy.

This perception that the government influences the investment decision of public sponsored pension funds does not seem to be particular to Brazil. Roberta Romano, discussing public pension funds and the debate over shareholder activism in corporate governance,[41] argues that public fund managers are subject to considerable political pressure to temper investment policies with local, state and federal government considerations, such as fostering in-state employment, which are not aimed at maximizing the value of their portfolios' assets. She mentions as an example that during the 1992 presidential campaign, Bill Clinton advocated using public pension funds to finance infrastructure projects.[42]

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[40] Estatuto da Caixa de Previdência dos Funcionários do Banco do Brasil, art. 1, *available at* http://www.previ.com.br/.

[41] *See* Roberta Romano, *supra* note 1, at 795.

[42] The conclusions of R. Romano are similar to the findings of K. J. Murphy and K. Van Nuys. Those authors conducted empirical research on the management of American pension funds in 1994. They were interested in analyzing the incentive and governance structures of state and corporate pension systems, focusing on the fact that decision authority in state systems is often vested in system participants and in the private system is often held by individual with fiduciary duties to the corporation--participants have relatively little control over management of the funds in pension funds sponsored by corporations. With respect to pension funds sponsored by public entities, the authors found that managers can easily draw negative attention from politicians and the press if their decisions generate negative investment outcomes. Their hypothesis is that, relative to privately sponsored pension funds, publicly sponsored funds are run by "caretakers," who manage the pension to reduce the chance of engendering negative attention from the press and politicians. This leads to particularly conservative investment behavior by state fund managers, who hold more of their portfolios in bonds, and less in equities, manage more of their assets in-house, and pay their outside money managers smaller, less performance-based fees than their corporate counterparts. With respect to pension funds sponsored by private entities, the authors also found significant conflicts of interest. U.S. corporate pension funds' assets are typically managed by the corporate pension fund managers. These managers are responsible for selecting and monitoring external money managers and

The government's influence over Previ was most apparent during the Brazilian privatization program. During and following Brazil's privatization program of the late 1990's, pension funds sponsored by companies controlled by the government were repeatedly criticized for being too involved with the companies or groups which supported the president at the time. Critics of the government believe that these funds were, and still are, making risky investments by financing certain companies or by taking part in consortiums in order to assure that the government's favorite buyers were successful in the privatization auctions.

These critics' arguments were supported by the contents of several tapes divulged by Folha de São Paulo, a major Brazilian newspaper, in 1998. These tapes include many telephone conversations, the most controversial of which was held between the president at the time, Fernando Henrique Cardoso, and the president of the Brazilian Development Bank (*Banco Nacional de Desenvolvimento Econômico e Social – BNDES*), André Lara Resende.[43] In this conversation, Lara Resende asked for the President's permission to use the President's name to pressure Previ's officers. Lara Resende wanted to make Previ participate in and contribute money to a certain consortium that would take part in the privatization auction of Telebras, the state-controlled telecommunication company. The President gave Lara Resende his permission.[44]

The public disclosure of this conversation had many political ramifications. Luiz

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allocating fund assets across asset types. These current managers generally report to the board of directors or one or more officers of the corporation who simultaneously serve as fiduciaries for plan participants and shareholders (as corporate officers). "*Thus, while individuals making investment and benefit decisions for corporate pension plans are fiduciaries for plan beneficiaries, they are also bound, through the corporate hierarchy, to a fiduciary responsibility to the shareholders.*" *See* Kevin J. Murphy & Karen Van Nuys, *Governance, Behavior, and Performance of State and Corporate Pension Funds* (Working Paper 1994), *available at* http://www-rcf.usc.edu/~kjmurphy/Pensions.pdf.

[43] Transcriptions of these tapes are available at http://www1.folha.uol.com.br/folha/circulo/pre_sp_3.htm.

[44] These tapes could not be used as evidence in judicial processes because they were illegally recorded.

Carlos Mendonça de Barros (the Minister of Telecommunication at the time), Lara Resende and a number of members of Previ's management were dismissed from their positions. In addition, as previously mentioned, stricter regulations of pension funds governance, which were enacted some years later, started to be drafted and discussed.[45]

Although not explicitly acknowledged as such, Previ is still treated as an arm of federal government. For instance, the fund rarely respects the limits imposed by regulations. According to Previ's Investment Statement regarding the first quarter of 2004, it has 58% of its assets invested in shares[46], eight percentage points above the maximum allowed by current regulations[47]. Moreover, the regulation sets forth that a pension fund should not hold more 20% of the total stock of a company[48]. The Investment Statement regarding first quarter of 2004 states also that Previ has investments that surpass 20% in 33 companies.[49] In some of these invested companies, Previ holds 100% of the total stock.[50]

These three examples point to many weaknesses in the pension fund governance structure. Particularly, they show many situations in which pension funds make decisions in the interest of their sponsors, regardless of the obligations these entities have to their participants. Part II, using agency theory, will establish a theoretical framework to explain the reasons for such occurrences.

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[45] *See* Lei Complementar no. 109 and Lei Complementar no. 108.
[46] Demonstrativo Analítico de Investimentos e enquadramento das Aplicações (segundo trimestre de 2004), *avaliable at* http://www.previ.com.br/pls/portal/docs/PAGE/PG_PREVI/PREVI_INVESTIMENTO_INTERNO/DAIEA2.PDF.
[47] Resolução do Ministério da Fazenda – Banco Central do Brasil No. 3.121, de 25 de setembro de 2003, D.O.U. 26.09.2003, art 25.
[48] *Id*. Art. 26.
[49] *Supra* note 46.
[50] *Supra* note 46.

2. THEORETICAL FRAMEWORK

2.1 Agency Theory and Pension Funds

There are three main players within a pension fund: (1) the sponsor, which is the employer or the group of employers, (2) the participants or beneficiaries (principals), who are the workers who participate in the pension plan, and (3) the fund managers (agents).[51] Agency theory can be applied to analyze the relationship among those players.[52]

From the perspective of agency theory, pension funds are a network of overlapping contracts that specify obligations for those key players. If sponsors, participants and managers had complete contracting ability, the parts would be able to agree in the most efficient plan structure and risk allocation for both sides, weighing the willingness to take risks, vigilance capacity and market expertise. However, these contracts are, as a general rule, incomplete and costly written and enforced. Principals rely on two mechanisms to protect their interest and their rights. The first mechanism is the law as it includes rules regarding fiduciary duties and conflict of interests and others that require managers to act in the best interest of principals. The second mechanism is the governance structure which may provide protection in two ways. First, an adequate

[51] The model described is the simplest possible model. Some countries use more complex models that include monitors and, external audit and validation agents.

[52] Agency theory addresses the costs arising from an agency relationship (agency costs). An agency relationship is a contract under which a person (agent) acts or performs services on behalf of another (principal), and involves, to some extent, the delegation of decision-making authority from the principal to the agent. Assuming that the principal and the agent seek to maximize their utility, the problems in the agency relationship arise from the fact that the agent does not always act in the best interests of the principal. Another assumption of agency theory is that the players will always act rationally from an economic perspective. In other words, individuals are always willing to act according to their self-interest. Agency costs are those which evolve from the different interests of the principal and agent. Such costs arise because the contract that regulates the relationship between agent and principal is not costlessly written and enforced. Agency problems arise when contracts are unable to sufficiently protect the interests of the principal. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 304 (1976).

governance structure can align managers' interests and principals' interests, minimizing the conflict situation. Second, an adequate governance structure may enable principals to exercise control powers over the managers and compel those in operating control of the organization to respect and pursue the principals' interests. There is a need to match the governance structure of the pension funds to the kind of pension contract being used and to the incentives of the various parties in such a structure.[53]

In defined benefit pension plans, participants are promised a pre-specified sum of money, received upon retirement. These benefits may vary depending on the participant's salary, years of service, and may allow for adjustments. The most distinguishing characteristic of the defined benefit plan is that the benefits do not depend on the amount contributed to the fund or on the performance of the fund assets. Therefore, theoretically, if the contributions and the assets are insufficient to meet the due payments, sponsors should increase their contributions in order to meet the obligations. On the other hand, if the assets exceed the amount required to meet the due payments, the excess could be returned to the plan sponsor[54] or the sponsor's future contributions could be reduced.[55] Thus, assuming that the fund always pays the agreed amount to the participants, in a defined benefit plan, the sponsor is the residual claimant because he/she is the one who bears the risk and has the ownership of the return.

In defined contribution pension plans, participants are promised a future sum, received upon retirement that is dependent on the performance of the assets that were invested in a pre-established manner. Therefore, the payout depends on the size of the

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[53] *See* Timolthy Besley & Andrea Prat, *supra* note 2, at 6.
[54] For example, in 1991, California's governor appropriated $1.6 billion from a surplus account at California Public Employees' Retirement System (CalPERS) and applied it to the state's budget deficit.
[55] *See* Murphy & Van Nuys, *supra* note 42, at 5.

contributions made and the performance of the assets. Unlike the ownership in defined benefit plans, the ownership of the return in defined contribution plans is held by the participant, making participants the residual claimants. Therefore, if the fund's investments perform poorly, sponsors do not suffer any consequences.

Summarizing, defined contribution and defined benefit plans allocate investment risk oppositely. Under a defined contribution plan, the participants (employee) bear the burden of disappointing investment results and pockets the gains from good results. Under a defined benefit plan the sponsor (employer) bears the investment risk.

In practice, there are also many combination plans that offer a defined benefit component which ensures participants a minimum payout upon retirement, and a defined contribution component. Theoretically, sponsors and participants share the risks in these plans so they, to some extent, both act as residual claimants.

An organization's efficiency depends on the allocation of decision rights and residual claims within the organization. Eugene Fama and Michael Jensen argue that decisions should be made by whoever bears the risk of the organization. According to the authors, many organizations are managed by individuals who are not the sole residual claimants and who therefore do not fully bear the financial consequences of their decisions. In such organizations it is important for the residual claimants to retain decision control rights over the management by maintaining the right to hire, fire, and set the compensation of the managers.[56]

Since the residual risk in relation to pension funds shifts from one part to another depending on the contractual structure, incentives of the various parties within a pension

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[56] *See* Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims,* 26 J.L. & ECON. 328, 327-349 (1983).

plan are defined by such contractual structure. Any desired behavior (and governance structure) has to be either contractible, at reasonable cost, or incentive compatible.

For instance, it will be more efficient if the sponsors control the investment decisions in a defined benefit plan, since he or she absolves the exceed returns and, as a result, has incentives to chose the most efficient investment allocation. In contrast, in defined contribution plans, it is preferable that participants control the assets allocation and management, because they have the ownership of the returns. The fact that sponsors do not bear the residual risk on defined contribution plans means that they will not take into account the effect of their investment decisions on the expected returns of the participants. The sponsor will be driven purely by her/his private interests. The opposite happens in defined benefit plans controlled by participants, as they neither perceive the excess of returns nor bear the insolvency risk, they will take decisions based exclusively in their own interest.

Another example is vigilance. The comparative advantage in monitoring rests on the allocation of residual claims. If residual claims are going to be borne by the sponsors, sponsors have more incentives to monitor. On the other hand, if the risk is going to be borne by the participants, participants would have more incentives to monitor. Consequently, in defined benefit plans, the sponsor has more incentives to monitor the managers, while in defined contribution plans, participants have more incentives to monitor the management members.

Monitoring activities are, however a tricky issue in defined contribution plans. Because of the presence of multiple participants in a defined contribution pension plan, it is important to keep in mind that participants have a jointly residual claim and each of them does not internalize the full outcome of additional vigilance, creating a free-riding problem which decreases the optimal level of monitoring. As a result, there is a reduction on the attractiveness of defined contribution plans, if compared to defined benefit plans. In addition, as monitoring is costly, and it is reasonable to think that sponsors have more resources than participants, theoretically in a defined benefit plan monitoring efforts would be more constant.[57]

Certain intermediaries, such as trustees or pension account managers that undertake the control power (appoint, hire and dismiss management) and monitoring task on behalf of the participants ("trustees"), can be thought as a possible solution to overcoming the free-ride problem. Theoretically, these trustees, if professional investors, would also be able to improve pension performance with regards to returns. The theory predicts that professional investors obtain larger returns than retail investors, since they have a lower cost of monitoring and they can also better predict assets price in the future. Therefore, supposedly assets perform better when administrated by professional investors. A third argument in favor of the adoption of professional investors as trustees to save the free-riding problem in defined contribution is effect of career concerns, given that the market provides strong career concerns. A professional investor that is perceived to be capable and competent would be able to get future rewards in the form of more lucrative or prestigious business.

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[57] *See* Besley & Prat, *supra* note 2, at 16-17. "The normative lesson is that we should give residual claim to the party with better monitoring skills…In practice most people would argue that the sponsor has a double advantage over beneficiaries. First, being a unitary player she does not face a free-riding problem. Second, she might draw on an in-house expertise to ensure proper monitoring. If it is true, DB (defined benefit) plans should display a better performance than DC (defined contribution) plans, and would provide a strong argument in favor of DB. To evaluate this statement, note that performance has two components: returns and costs."

However, trustees can create other problems to the governance structure. First, the introduction of trustees creates a new agent/principal relationship that implies a new set of agency problems to be addressed. Second, the trustees' services are costly and they may impose a significant reduction of participants' wealth. Both problems are significant and in ways puzzling.

To help thinking about the first one it would be adequate to use the corporate governance scholarship. The role of this literature has been in finding existing and potential agency problems and trying to propose the most efficient governance mechanisms to solve those problems. Therefore, there is vast literature that could help to address the agency problem, especially in a defined contribution plan where it is possible to develop a structure by which the compensation of the trustee would be directly linked to the performance of the assets. The second problem however seems to be more puzzling to solve in theory and practice. In countries that have adopted a contractual structure that include trustees, the high costs of financial intermediaries' services (that function as trustees or pension account managers), is one of the main criticisms. In the Chilean case, for example, the privatization of the pension system created the *administradoras de fondos de pensiones.* The very high administrative costs imposed by the remuneration of the services provided by these entities represent one of the most problematic drawbacks for Chilean workers. Costs can run as high as 30% to match similar coverage provided at about half the cost by the U.S. Social Security system. The system has been criticized by some as being over five times as expensive as that of the United States, and perhaps the most expensive in the world.[58] In the United Kingdom, the estimate is that administrative costs of management of the individual accounts take away 25% of the pension value.[59]

In conclusion, it is worthwhile to restate some of the prepositions developed above. First, pension funds are a network of overlapping incomplete contracts, where each player will act according to its own interest unless there is some kind of match between governance structure and incentives of the various parties in such a structure. Those incentives will depend on the contract chosen and who is the player bearing residual risk. In case of pension funds, defined benefit or defined contribution contracts are the most common structures. The role of the governance rules in pension funds is, first, to ensure that pension plan members are adequately protected from conflicts of interest and related problems, and, second, to guarantee that the governance structure is compatible with the incentives of the players or to at least provide contractual provisions that enable the players to overcome any incentive incompatibilities.[60]

2.2 Hypothesis of Reaction to the Brazilian Legal Framework

The aim of this Section is to predict how sponsors, under the current legal framework described above in Sections 1.2 and 1.3 and in light of the tools of agency theory discussed in Section 2.1 above, would write their contracts, particularly with regards to the governance rules of EFPCs.

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[58] *See* Kristen V. Campana, *Paying our Own Way: the Privatization of the Chilean Social Security System and its Lessons for American Reform* 20 U. Pa. J. Int'l Econ. L. 385, 402 (1999).

[59] *See* Steve Idemoto, *Pension Privatization in Britain: A Boon to the Finance Industry, a Boondoggle to Workers*, 2000 ECON. OPPORTUNITY INST., *available at* http://www.econop.org/SocialSecurity/SS-SocialInsecurityBritain.htm.

[60] *Compare to* JUAN YERMO & ANNAMARIA MAROSSY, *supra* note 32.

It is necessary to make three initial observations in order to make a coherent analysis of the governance of Brazilian pension funds (EFPCs). First, the formal contract between sponsors, managers and participants is the by-laws of the pension funds. Sponsors have sole responsibility for writing such documents, as long as they respect the legal provisions and limitations. They have no obligation to listen to or ask for inputs from employees. Once the by-laws are written, they must be approved by the Complementary Pension System Secretariat (*Secretaria de Previdência Complementar*).[61]

Second, Brazilian regulation makes no distinction between the entities that offer defined benefit plans and the entities that offer defined contribution plans, despite the fact that such plans have totally different contractual and incentive structures. In fact, virtually all the pension funds that comprise the sample of empirical research described in Part III of this paper offer both defined contribution and defined benefit plans, and they also often offer mixed plans which are comprised of a defined benefit part and a defined contribution part.

Third, as mentioned before, participants are the residual claimants in the Brazilian pension funds contractual structure. They are the ones who ultimately bear the risk in the event that the pension fund becomes insolvent.

The hypothesis stated below as to how sponsors write pension funds' by-laws relies upon two assumptions. First, the hypothesis assumes that all sponsors' choices are driven by their self-interest. Therefore, whenever sponsors have a choice between two or more ways to act, it is assumed that they will pick the one that maximizes their utility and minimizes monitoring. Second, the hypothesis assumes that sponsors will comply with

[61] Lei Complementar No. 109, de 29 de Maio de 2001, D.O.U. de 30.05.2001, art. 33.

the law. Therefore, in writing the by-laws of pension funds, the sponsor will only attempt to control the decision making process or to otherwise maximize their utility when the law does not impose the opposite.

Considering the observations and assumptions above, it is reasonable to say that sponsors will write the by-laws of the pension funds in compliance with the minimum requirements imposed by law and in a way that gives them as much power as possible over the decisions of the entity so that the decisions of the pension fund maximize their interests. Furthermore, they will only give to participants the minimum powers required by law and they will embrace more control power whenever they have an opportunity to do so. The exact dimension of this hypothesis in relation to each of the aspects of the Brazilian pension funds' governance structure analyzed in the empirical research described in Part III is further detailed below.

2.2.1 Management Structure

Management structure is the formal arrangement an organization has set up in order to make policy decisions, to set a long-term direction for the firm and to manage financial decisions.

As explained in Section 1.2 above, Brazilian law sets forth a mandatory three tier structure including: (1) a *conselho deliberativo* (a deliberative council); (2) a *diretoria executiva* (executive officers); and (3) a *conselho fiscal* (a fiscal council). The first two bodies have managerial functions, while the third one has a monitoring function. Since this research focuses on the decision-making process, the analysis of by-laws conducted in the empirical sections focuses on the features of the *conselho deliberativo* (deliberative council) and *diretoria executiva* (executive officers). There is not apparent reason for by-laws to change this structure in order to ensure control of the sponsors over pension funds decision. That said, with regards to the management structure, the hypothesis is that, in compliance with the law, all the pension funds will adopt two management bodies: (i) a *conselho deliberativo* – deliberative council; and (ii) a *diretoria executiva* – executive officers.

2.2.2 Composition of the Management Bodies

As mentioned above, the by-laws of pension funds sponsored by private entities must demand that at least one third of the deliberative council is composed of employees of the fund. Publicly-sponsored pension funds are faced with a more detailed set of governance rules including that the proportion of participants' representatives is one half and the members of the deliberative council are non-removable.

Under agency theory assumptions, one would predict that sponsors will respect the minimum representation of participants in the management bodies as required by law but they will not include more than is required. Moreover, whenever the law permits, they will implement mechanisms that empower the sponsors' control power and weaken the participants' control power.

Therefore, the composition of the deliberative councils of pension funds will likely be as follows: (i) one third of the deliberative council of pension funds spnsored by private companies will be participants' representatives; and (ii) one half of the deliberative council of pension funds sponsored by public companies will be participants' representatives, however sponsors will keep tie breaker powers, in compliance with the law.

The executive officers of pension funds will likely be as follows: (i) executive officers of pension funds sponsored by private companies will be either appointed directly by the sponsor or by the deliberative council (in which the majority of two thirds of the members are appointed by the sponsor), and these officers will be removable; (ii) executive officers of pension funds sponsored by public companies will be either appointed directly by the sponsor or by the deliberative council (in which the sponsor has tie breaker powers), and these officers will be removable; and (iii) as there is no legal minimum requirement of participant representation, the proportion of participant representatives among executive officers will significantly drop if compared to the same number in relation to deliberative councils or simply will not exist.

2.2.3 Requirements for the Members of the Management Bodies

The Brazilian law sets forth that the individuals to be appointed to the deliberative council must (1) have previously participated in financial, management or accounting activities; (2) not have been convicted of any crime; and (3) not have been convicted in any administrative process for violation of the regulations set by the social security system or for any other infractions as a public employee. In addition to these requirements, a graduate degree (in any discipline) is required of executive officers.

The former of these requirements relates to a material characteristic, but it is rather ample. The latter two requirements are pretty formal. Therefore, it is possible to say that the legal requirements provide both sponsors and participants with a lot of flexibility to appoint whoever they want to the management bodies, as long as this person has some experience in finance, management or accounting. As this flexibility is desirable from an agency theory perspective, the hypothesis is that the by-laws will either adopt the requirements imposed by law or will impose new requirements that limit those individuals in the management bodies to those individuals under the sponsor's control or influence who will therefore be more likely to succumb to the sponsor's pressure.

Part III describes the empirical research conducted, the findings of the research and compares the findings with the predictions above.

3. RULES OF GOVERNANCE IN PENSION FUNDS' BY-LAWS

This Section presents the findings of the empirical research conducted on the by-laws of Brazilian pension funds, whose description of the methodology and main results are in Appendix I. It also compares such findings to the hypotheses described in Section 2.2 above and with the theoretical contractual optimal structures described in Section 2.1.

3.1 Management Structure

All the pension funds of the sample comply with the minimum requirement established by the law with regards to the structure (see Table A below). More than 93% of the sample adopts exactly the management structure proscribed by law which is to have two management bodies (deliberative council and executive officers). Two of the multi-sponsored pension funds, corresponding to 6.6% of the sample, in addition to the minimum structure, adopt a third body which aggregates all the sponsors.

Table A

Law Compliance

	Percentage of Compliance		
Law Requirement	Pension Funds Sponsored by Public Entities	Pension Funds Sponsored by Private Entities	Total
2 management bodies	100%	100%	100%
1/3 of the participants representatives in the deliberative council	100%	86.66%	93.33%
deliberative council with powers to elect the executive officers	86%	-	86.66%

The most interesting finding of the analysis of the management structure, however, is not with regards to the number of bodies, but, rather, in regards to the functions of these bodies, which is also established by the bylaws. The traditional model of two tier management assumes a hierarchically-higher body, generally called the board of directors, whose members are elected by the principals.[62] This hierarchically-higher body is responsible for the task of determining the entity's policies and main business decisions. This higher body is normally a collective decision body, whose members have no or very little power when acting as individuals. The members of this body are not involved in the day-to-day administration but they set the limits and goals to be pursued by the ones responsible for it. This body participates in business affairs of the entity through its selection of the chief executive officer and other executive officers, and to some extent through the exercise of other functions, including oversight, establishment of compensation levels, and perhaps approval of major transactions. Therefore, one of the main functions of this body is to elect and remove the member of the second body who will be in charge of the day-to-day decisions.

The members of the second body are commonly called executive officers. In theory, officers carry out the day-to-day affairs of the entity subject to guidance and control of the board of directors. In fact, the authority of the officer in relation to business decisions is considerably greater, as directors are hardly ever consulted for decisions of the day-to-day business of the entity. The role of directors in virtually all

[62]This is the typical structure of corporations in America and in Brazil. The management structure of corporations is comprised of a board of directors and officers. The board of directors is a collective-decision body entrusted with powers to approve the main business decisions and to establish the policies of the corporation while the officers, who are elected and removed by the directors, are in charge of the day-to-day business decision. *See* ROBERT W. HAMILTON, CORPORATIONS 255-257 (West Publishing Co. ed., 4th ed. 1997) (1982).

day-to-day business affairs is to approve the respective financial statements. Therefore, they are almost never involved in business decisions. Some might disagree because the officers approve the financial statements, but this happens after the business decision is already made and implemented. Since the power over business decisions of the board of directors is reduced, the board's main responsibility is to elect the executive officers.

This function is particularly important in Brazil because there is a fundamental difference in the management structure of corporations. In America, at least formally, the board of directors of a corporation is the central management authority. All corporate power and authority flows from the board to the other bodies of the corporation, including to the executive officers, and therefore, the board has the power to bind the corporation. In Brazil, the board of directors of a corporation is the hierarchally-higher body that appoints the officers but not all the powers of the officers are granted by the board as some of them are statutory. For instance, the officers have the exclusive power to bind the corporation. While officers may need the board's approval for certain transactions, the capacity of representing and binding the corporation is exclusively held by the officers.[63] As in Brazil, some of the powers are traditionally reserved for the officers, the board of directors has limited powers so the election and removal of the officers becomes even more important.[64]

Considering that the deliberative council of pension funds plays the role of the hierarchically-higher body (board of directors) in the model described above, that the executive officers of pension funds are the executive officers, and that the law imposes only a minority compulsory presence of participant representatives in the composition of

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[63] *See* Lei No. 6.404, de 15 de Dezembro de 1976, Capítulo XII.
[64] *See* ROBERT W. HAMILTON, *supra* note 62, at 255-257.

the deliberative council, it is clear that participants have limited influence over business decisions.

In addition, for a significant part of the Brazilian pension funds analyzed, this typical structure has been changed in a way that further weakens the power of the deliberative council. With regards to privately sponsored pension funds, where the law does not provide minimum functions for the deliberative councils, 8 out of 15 (53.33%) entities had their by-laws drafted in a way that the function of electing the executive officers was transferred from the deliberative council to the sponsor. In these funds, the sponsor is directly responsible for appointing the officers (see Appendix I, Findings – Analysis). Therefore, for most of the privately sponsored pension funds, the deliberative council has been stripped of its main power.

This is also seen in the pension funds sponsored by public entities, in relation to which the law expressed set forth that the deliberative council should be the body with power to elect the executive officers (see Section 1.2 above). 5 out of 15 of these (33%) pension funds put the sponsor in charge of appointing the managers (2 out of 15—13.33%) of or have separate elections for the executive officers elected by the sponsors' representative and those elected by the participants' representative, provided that the chief executive officers and financial officers are elected by the sponsor representatives (3 out of 15—20%).

The by-laws of pension funds may reduce the discretion of the deliberative council in other ways. For instance, in the pension fund *Economus*, the deliberative council is the management body responsible for appointing the officers. However, the deliberative council must pick the names of the officers from a list prepared by the sponsor. Therefore, although one might argue that technically the by-laws give the deliberative council the choice among the sponsor's appointees since the council has the ultimate decision, it is difficult to believe that those individuals on the sponsor's list are not somehow linked to the sponsor's interests, and are, therefore, under the sponsor's sphere of influence.

To sum up, although the two tier structure set forth by law is respected by sponsors in drafting pension funds' by-laws, other mechanisms are frequently used to reduce the functions, responsibilities and powers of the deliberative council, a body in which participants' representatives have seats. The transfer of power to elect the executive officers from the deliberative council to the sponsor is a particularly common method of reducing the deliberative council's power.

3.2 Composition of the Management Bodies

The findings of the empirical research on the composition of the management bodies differ slightly from the hypothesis posed in Section 2.4 above. However, they are not incompatible with rational behavior under agency theory principals and assumptions since the sponsors, in writing the by-laws, found a different way to manifest their rational behavior from an economic point of view. Table B below summarizes the findings with regards to the average proportion of participants' representatives in the management bodies of the pension funds analyzed.

Table B

Composition of the Management Bodies

	Pension Funds Sponsored by Private Entities	Percentage Required by law	Pension Funds Sponsored by Public Entities	Percentage Required by law
Participants' representatives in the deliberative council	37.47%	33.33%	50%	50%
Participants' representatives as executive officers	5% to 9.9%	-	7.7% to 41.11%	-

With regards to pension funds sponsored by private companies, the findings show that 13 out of 15 of those entities (86.66%) comply with the regulation regarding the composition of the deliberative council (see Table A above). In relation to the remaining 2 pension funds, less than one third of the representatives of the deliberative councils, however, are participants' representatives as it is required by law.

Unlike the predictions, 5 out of 15 of the privately sponsored pension funds (33.33%) have more participants' representatives in their deliberative council than they are required to have by law. Participants' representatives, however, do not make up a majority of any of the deliberative councils of these funds. More importantly, all of the by-laws of these five pension funds take from their respective deliberative councils the power to elect the executive officers. In other words, sponsors wrote the by-laws to give participants' greater representation than required by law, but took from the deliberative council its most important power, as explained in Section 3.1 above.

Due to this quite innocuous over-representation, the average proportion of participants' representatives in deliberative councils among the sample of pension funds sponsored by private entities is 37.47%. This number is 4.13% greater than required by the law. Table C below shows the correlation between the composition of the deliberative council and the power to elect the executive officers. Interestingly, on the one hand, pension funds which by-laws give to the deliberative council the power to elect the executive officer, in average, have in these bodies fewer seats to participants' representatives than the minimum required by law. On the other hand, when the function of electing the executive officer is allocated to the sponsor or sponsors and participants elect their representatives among the executive officers separately, more seats in the deliberative councils are reserved to participants' representatives in average. This data provides evidence that the sponsors in drafting pension funds by-laws tend to give more seats to participants when deliberative councils are weak bodies, and less seats when the deliberative councils have power to elect the executive officers.

Table C

Composition of the Deliberative Council Correlated to the Power of Electing the Executive Officers – Pension Funds Sponsored by Private Entities

Allocation of powers to elect the executive officer	Representativeness in relation to the sample	Actual proportion of participants' representatives in the deliberative council	Minimum percentage of participants required by law	Under or over compliance
Deliberative council	26%	26.43%	33.33%	- 6.8% Under compliance
Sponsor	53%	40.57%	33.33%	7.24% Over compliance
Separate elections – 1 officer appointed by the participants and 3 appointed by the sponsor	20%	41.63%	33.33%	8.3% Over compliance

When analyzing the executive officers the representation of participants drops drastically. The average proportion of participants' representatives who are executive officers varies between 5% and 9.9%. This variance is caused by the 5 pension funds (33.33%) that have 100% of their executive officers appointed by the deliberative council. These deliberative councils are partially composed of participants' representatives but the decision in this body is made collectively by the majority of the members. Therefore, even though the participants are represented, they might not have much influence over the election of the officer since they have a minority representation (average of 37.47%). As it is impossible to determine exactly how influential are the participants' representatives in the election of the executive officers, these percentages represent a range of power that varies from 0 (no power as a result of the majority system) to 37.47% (as the participants' representatives were able to elect the same proportion of executive officers as the proportion of representatives in the deliberative council).

With regards to pension funds sponsored by public companies, the findings show that 100% of these entities are in compliance with the law (see Table A above). Therefore, the ratio of participation of participants' representatives to sponsors' representatives in deliberative councils is 1:1. However, due to the tie break power given to the sponsors' representatives and different arrangements in the by-laws of these entities, the proportion of participants' representatives who are executive officers varies between 7.7% and 41.11%. This variance is caused by the 10 pension funds (66.66%) that have 100% of their executive officers appointed by the deliberative council, from which the president is appointed by the sponsor and has tie-breaker powers.

Even though participants and sponsors are equally represented in the deliberative council, participants might not have much influence over the election of officers since the president has the power to decide in the event of a tie. Again, as it is impossible to determine exactly how influential are the participants' representatives in the election of the executive officers, these percentages represent a range of power that varies from 0 (no power as a result of the tie breaker vote of the president of the council) to 50% (as the participants' representatives in the deliberative council were able to elect executive officers in exact proportion to their participation in such body).

The analysis of the structures described above, both of privately and publicly sponsored pension funds, demonstrates very high agency costs. This contradicts Eugene Fama's and Michael Jensen's[65] optimal structure for the management of pension funds, since the decisions are not made by the bearers of the residual risks of the organization. In addition, theoretically, in organizations that are managed by individuals who are not the sole residual claimants and who therefore do not fully bear the financial consequences of their decisions, it is important for the residual claimants to retain decision control rights over the management by maintaining the right to hire, fire, and set the compensation of the managers. Therefore, it would be necessary for participants to have control over the managers. As shown by the findings, this is not the case in Brazil.

No matter what kind of plan is adopted (defined benefit or defined contribution), participants of Brazilian pension funds bear insolvency risk and sponsors design the management structure and control the investment and management decisions. Moreover, participants have no control rights, since in all cases they only have a minority voting power making it difficult to achieve their goals. Therefore, under an agency cost

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[65] *See* Eugene F. Fama & Michael C. Jensen, *supra* note 56, at 327-349.

analysis, the structures of Brazilian pension funds are highly inefficient.

This theoretical analysis suggests that one way to reduce agency costs and to mitigate sponsors' influence over investment and management decisions of pension funds, would be to ensure that fund boards have a majority of participant-elected members.[66]

However, empirical research done by R. Romano with public pension funds in the USA suggests that a wholly-workers-elected board is not necessary, and questions whether a specified proportion of elected members is optimal.[67] On the contrary, the performance of the pension funds improved as elected members were added to a board, but declined once they made up a critical mass of the board.[68] If this is generally true, the Brazilian governance system in pension funds should be adequate, since the law requires pension funds to have some level of participants' representation and most of the pension funds comply with the law. On the other hand, the scandals and illegal behavior described in Section 1.4 provide evidence that the system is somehow inadequate. Something must be wrong with the system if such incidents occur.

This same research also found evidence that non-elected members have a greater ability to influence investment decisions when there is a greater number of elected

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[66] Moreover, some commentators believe that defined contribution plans would be a socially preferable structure for a pension system. Those scholars believe that the egalitarian goals of the socialist vision are more compatible with defined contribution plans. In their opinion, public insurance arrangements for defined benefit plans are prone to unfair cross-subsidization of different classes of workers and a system limited to defined contribution plans would still produce inequality since less successful funds would have lower returns than more successful ones. However, in such a system the high returns would be less socially concentrated and less correlated with other dimensions of a social position than they would be in a defined benefit system. *See* William H. Simon, *The Prospects of Pension Fund Socialism*, 14 BERKELEY J. EMP. & LAB. L. 251, 255-256 (1993).
[67] *See* Roberta Romano, *supra* note 1, at 840-842.
[68] *See* William H. Simon, *supra* note 66, at 260-266 (discussing the potential conflicts between the diverging interests possessed by workers in different positions within the pension funds).

members who have less investment experience than other members.[69] If this were the case in Brazil, structural protections could be adopted to limit problems that would result from having financially inexperienced participants' representatives on the board. R. Romano suggests, for instance, that the law could require that all or some number of elected board members meet minimum expertise requirements, or that the government could provide board members with rudimentary financial training. Also, the government could establish advisory councils composed of individuals with investment expertise to provide recommendations to fund boards concerning investment strategy. However, in the Brazilian case, the participants' representatives' lack of experience in management and finance do not seem to be the only reason for these individuals to follow the sponsors' representatives' opinions. As explained in Section 3.3 below, the Brazilian legal framework allows the sponsor to draft the by-laws of pension funds in a way that enables the sponsors to give their own officers, employees, agents, or other representatives positions as managers. These individuals will have fiduciary or contractual duties towards the sponsor which means the sponsors have a strong influence over their decisions.

Another argument that is often used to highlight the problems and limits of employee control over pension funds boards is the fact that employees have diverse interests so conflicts may arise among various subgroups.[70] For example, a potential conflict of interest exists between senior and junior workers. Senior and junior workers tend to have different interests and perspectives from each other. Senior workers are often more intensely concerned with the preservation and enhancement of retirement

[69]Roberta Romano, *supra* note 1, at 842.
[70] *See* Daniel Fischel & John H. Langbein, *Erisa's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1120-1126 (1988); *see also* William H. Simon, *supra* note 66, at 259-266.

benefits while young employees are often more concerned with the long-term prospects of the pension fund. Similarly, participants often disagree on the choice between retirement security and employment security. For instance, retirees face no tradeoff between pension benefits and employment compensation. From their perspective, pension benefits always prevail, even though some current workers might lose their jobs as a result. The same is not true for younger employees. Not only do they have less wealth tied up in the pension plan, but they also are more concerned with keeping their jobs than with their pension benefits.[71]

Another possible hypothesis for the failing in the system of participants' representation in the Brazilian case is the process by which the participants' representatives are elected. The findings suggest that the most significant part of the election process of participants' representatives is controlled either by the sponsor or by the pension fund. There is no guarantee that regulation of this process will ensure that the sponsor or the pension fund does not influence the result of the election or the participants' voting decisions. It is therefore necessary to conduct empirical research on the election process of the participants' representatives to find out whether it is adequate.

Therefore, before suggesting an increase in the number of participants' representatives in the board of Brazilian pension funds as a mechanism to minimize agency costs, it is necessary to further investigate the reasons for the inadequacy of the current structure, what other measures would be necessary to guarantee that the representatives of the participants were indeed advocates of the participants' interests in this body and what other problems such reforms could cause.

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[71] See Daniel Fischel & John H. Langbein, *supra* note 70, at 1120.

3.3 Requirements for the Members of the Management Bodies

Section 2 above explains that the requirements set forth by Brazilian law in relation to the qualification of the members of the management body are either formal or excessively vague. As a result, unless otherwise established in the by-laws of the pension funds, the legal requirements provide both sponsors and participants with a lot of flexibility as to who they want to elect to the management bodies. As this flexibility is desirable from an agency theory perspective, one can expect that the by-laws will adopt either only the requirements imposed by law or will impose new requirements that limit the occupancy of the positions in the management bodies to people under the sponsor's control.

This rule allows the sponsor to draft the by-laws of pension funds in a way that enables sponsors to have their own officers, employees, agents, or other representative serve as managers. Sponsors routinely exercise this authority as showed in the findings. For instance, virtually all the by-laws require the managers to be either participants or employees of the sponsor. Moreover, some of them require that the managers of the sponsors keep at the same time the functions of the manager of the pension fund. For example, the CEO of Banco Itaú, the sponsor of Fundação Itaubanco which is the fourth largest privately sponsored pension fund in Brazil, is also the president of the deliberative council of the fund. This individual owes fiduciary duties to both entities.

The problem in electing these individuals is that they frequently owe either contractual or fiduciary duties to the sponsor. The individuals that perform management functions in both the sponsor's enterprise and the respective pension fund owe fiduciary duties to both entities.[72] Individuals that perform management functions in the pension fund and some other function in the sponsor's enterprise are under a contractual relationship (employment agreement) that which means the sponsor has some power over the manager of the pension fund. The fact that the managers of the pension funds are also individuals that have contractual or fiduciary obligations in relation to the sponsor creates an obvious tension with these individuals' duties. In other words, these rules permit funds to have non-neutral managers, rather than insisting upon neutral employee-chosen fiduciaries or upon a wholly independent fiduciary (chosen, for example, in the manner of an arbitrator).

Not only does this legal framework create a conflicting situation for the manager of pension funds, but it also allows the sponsors to compromise the managers' of the pension funds loyalty for the satisfaction of their professional interests. For example, an elected participant representative may think that the position he takes on the pension fund's decisions involving the sponsor's interests will impact his future promotions and wage increases, either because such a representative expressly was told so by his superiors or because the sponsor signaled this by favoring the participants' representatives who support the sponsor's interests and punishing those who take positions against the sponsor's interests.

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[72] Directors and officers of corporations in Brazil have a statutory fiduciary duty towards the company and its shareholders. Lei No. 6404, de 15 de Dezembro de 1976: "[a]rticle 154. An officer shall use the powers conferred upon him by law and by the by-laws to achieve the corporation corporate purposes and to its best interests the public at large and the social role of the corporation.
Paragraph 1. An officer elected by a group or class of shareholders shall have the same duties toward the corporation as the other officers and shall not fail to fulfill such duties, even at the expense of the interests of those who elected him. (…)
Article 155. An officer shall serve the corporation with loyalty, shall treat its affairs with confidence and shall not: (…) II - fail to exercise or protect corporation rights or, in seeking to obtain advantages for himself or for a third party, fail to make use of a commercial opportunity which he knows to be of interest to the corporation."

In the simplest scenario, a decision will involve a choice between the opposing interests of the sponsors and of the pension funds' participants. However, some of these decisions will involve the managers' own set of interests and sometimes managers may see advantages in siding with either the sponsor or participants. In that sense, it is important to remember that the sponsor hires and can fire these managers and controls their promotions, increases in wages and other incentives that may lead the managers to take the sponsors' side. As a result, it is reasonable to believe that, facing a conflicting decision; managers would prefer to vote in support of the sponsors' interests rather than in support of the participants' interests.

By-laws of some of the pension funds contain clauses that prohibit remuneration to the manager which shows that the workers' representatives have more incentives to act in accordance with the sponsor's interests rather than in accordance with the participants' interests. Further, these clauses establish that any of the managers' efforts and time spent on the performance of their responsibilities as managers of the pension fund will be considered efforts and energies devoted and time consumed in rendering services to the sponsor. While it is not possible to determine exactly how common this practice is since most of the pension funds do not have a compensation provision in their by-laws, at least 3 of the pension funds sponsored by private entities, which corresponds to 10% of the whole sample, do this.

In conclusion, the dual fiduciary obligation faced by the managers of the sponsor that are also managers of the pension fund, or the conflicting position of the employees that are managers of the pension fund and have an employment agreement, indeed appear to contrast markedly with the supposed duty of exclusive loyalty to the participants of pension funds imposed by agency theory principals. To resolve this problem, the Brazilian legislature should rethink the current structure and try to find mechanisms that could guarantee a more neutral and independent management for the pension entities.[73]

[73] The literature on independent directors in corporations provides useful background information on this topic. *See* Victor Brudney, *The Independent Director -- Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982); *see also* Richard E. Gutman*, Requirements of Independent Directors* 657 PLI/Comm 205 (1993); *see also* Stephen M. Brainbrigde, *Independent Directors and ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034 (1993).

CONCLUSION

This work draws both theoretical and empirical conclusions. From a theoretical standpoint, it shows that Brazilian law on governance of pension funds allows the sponsors (employers) to write the contract (by-laws) that will regulate the relationships between themselves, the managers and the participants (employees) within the organization. Further, assuming that sponsors behave as self-interested players who aim to maximize their own welfare, this thesis predicts that sponsors will write the contracts of pension funds (by-laws) to minimize monitoring and to maximize control over business decisions to the greatest extent permitted by law. Moreover, it demonstrates that the Brazilian legal framework forces participants to take on the risk of failure of the pension fund.

An agency theory analysis of this legal framework suggests that it is inefficient in many ways. In organizations managed by individuals that are not the sole residual claimants, control rights (right to hire, fire and set compensation) should be retained by whoever bears the financial consequences of decisions within organization. This is not the case for pension funds in Brazil. On the one hand, while sponsors have the authority to determine who will have control power over the management and investment decisions of the pension fund, the sponsors do not bear the residual risks of the organization. On the other hand, participants have very limited control rights over pension funds, but they bear the residual claim of the organization. Decision rights and residual risks are inefficiently allocated within the organization.

The second set of conclusions comes from the empirical research conducted. To ensure that the sponsors exercise the authority granted by law - writing the by-laws in a way that they keep control over the management and investment decisions of pension funds - the governance provisions in the by-laws of 30 Brazilian pension funds were examined. The criteria used in choosing the sample studied was the amount of investment assets and these 30 pension funds comprise approximately 76% of the total number of pension funds in Brazil.

The empirical evidence reported in this thesis confirms the predictions as it demonstrates that sponsors write the governance clauses of pension funds by-laws in a way to maximize control over business decisions to the greatest extent permitted by law. The findings showed that various mechanisms are used by sponsors to reduce the functions, responsibilities and power of the deliberative council, a body in which participants' representatives have seats. Particularly, sponsors draft the by-laws in such a way to limit the power of the deliberative council by limiting the council's ability to elect the executive officers and managers in charge of the day-to-day administration of the pension fund.

The findings also demonstrate that participants' representation in the deliberative council is generally fairly significant but participants' representatives are never the majority. However, it the participants' representation drastically drops in relation to the executive officers. The findings suggest that this number can be as low as 5% in pension funds sponsored by private entities and 7.7% in pension funds sponsored by public entities. This fact, combined with the reduction of power of deliberative council highlighted above, demonstrates that participants have very limited influence over the governance of pension funds.

Finally, there is evidence that most by-laws require that the members of the administrative bodies are either employees of the sponsor or the participants which means that most members are employees of the sponsor. The problem in electing employees of the sponsor as managers of the pension fund is that they owe contractual or fiduciary duties to the sponsor, which creates an obvious tension. The managers of the pension funds are, as a rule, non-neutral and therefore they constantly face conflicts of interests.

As a general conclusion, all these problems suggest that a debate would be worthwhile to discuss how to best reform this structure of pension funds' governance in Brazil both for the sake of the workers that currently participate in the system and also for the public employees that will soon be integrated to it as a result of the recent constitutional amendments.

Before evaluating all of the possible proposals it is necessary to theoretically and empirically evaluate many other issues. For instance, in considering the suggestion that an increase in the number seats for participants' representatives would reduce agency costs, it is necessary to assess what factors would ensure a fair and independent election of these representatives. It would be necessary to consider what kind of qualifications, protections and duties the law would have to give to these individuals in order to ensure that they act in the best interests of the participants. Similarly, in considering the use of a trustee or intermediary to aid the communication between the sponsors and participants, it is necessary to discuss the agency problems that would arise as a result of this new player and to consider how this new player would increase the administrative costs of the pension funds.

This thesis demonstrates that the current system is theoretically and empirically inefficient and problematic but it also acknowledges that further research is necessary before any concrete proposals can be made. The findings and conclusions reached by this thesis are only a first step for the discussion; nevertheless, this thesis shows that any reform proposal should take into consideration the agency problems discussed above, matching incentives, control powers and risk allocation.

APPENDIX I

I. THE EMPIRICAL RESEARCH

1. The sample

The Research adopts a non-probability sampling method[74]. The sampling criteria was: (i) magnitude, measured by the total value of the investment assets of each pension fund, and (ii) the nature of the sponsor, public or private entity. The initial sample for pension funds sponsored by private entities includes the 15 largest entities of this kind, according to the data made available in the rankings published by the *Secretaria de Previdência Complementar do Ministério da Previdência Social* on January 28, 2005[75]. However, since information on the funds classified as number 7 (HSBC), number 12 (Previ –GM), number 14 (PPS-Philips), and number 18 (VWPP) could not be found, they were replaced by number 16 (Elos), 17 (Fundação Attílio Francisco Xavier Fontana) and 19 (Fibra). The initial sample pension funds sponsored by public entities includes the 15 largest entities of this kind, according to the data made available in the rankings published by the *Secretaria de Previdência Complementar do Ministério da Previdência Social* on January 28, 2005[76]. However, since information on the fund classified as number 14 (CAPEF) could not be found, it was replaced by number 16 (Ceres).

As this research does not adopt any of the probability sampling methods, it is not possible to extend the results of this empirical research for the whole population of

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[74] Probability methods generally use statistical random selection and aim at creating a representative sample which contains the same variations that exist in the actual population.
[75] Ranking de Investimentos das EFPC - Posição em 28 de janeiro de 2005, avaliable at http://www.previdencia.gov.br/spc/docs/ranking_de_Invest_EFPCs_em_28_01_05.pdf.
[76] Ranking de Investimentos das EFPC - Posição em 28 de janeiro de 2005, avaliable at http://www.previdencia.gov.br/spc/docs/ranking_de_Invest_EFPCs_em_28_01_05.pdf.

Brazilian pension funds. However, the sample represents 39.88% of the whole population if the number of beneficiaries is considered and 76.13% of the whole population if the investment assets value is considered.

2. Observations in Relation to the Sources and Coding

All the bylaws analyzed were downloaded from the respective pension fund or its sponsor's website in February 2005.

All the statistical data was collected from official documents made available by the *Secretaria de Previdência Complementar do Ministério da Previdência Social* (the Complementary Pension System Secretariat), a governmental body linked to *Ministério de Previdência Social* (Social Security Ministry).

Information regarding the structure, size and appointment of the members of the management bodies of the pension funds were the primary data collected when coding.

II. FINDINGS– ANALYSIS

1. Size

a. Pension funds sponsored by private companies:

- The size of the Deliberative Council averaged 8.13, with a range of 5 to 18.
- The number of the Executive Officers in public pension funds averaged 3.8, with a range of 3 to 5.

b. Pension funds sponsored by public companies:

- The size of the Deliberative Council averaged 6 members, with no range –all the pension funds had a Deliberative Council made up of 6 members.
- The number of the Executive Officers in public pension funds averaged 3.7, with a range of 3 to 6.

2. Term of office

a. Pension funds sponsored by private companies:

- The term of office of the member of the Deliberative Council averaged 3.14 years, with a range of 2 to 5.
- The term of office of the Executive Officers averaged 3.16 years, with a range of 1 to 4.

b. Pension funds sponsored by public companies:

- All the terms of office of the member of the Deliberative Council are 4 years.
- The term of office of the Executive Officers averaged 3.35 years, with a range of 1 to 5.[77]

3. Removability

a. Pension funds sponsored by private companies:

- In 14 out of 15 pension funds (93.33%), the members of the Deliberative Council are removable at any time during the term of the office. 1 out of 15 pension funds

[77] One of the pension funds has an indeterminate term for their officers.

(6.66%) guarantees non-resolvability to the members of the Deliberative Council elected by participants during the term of the office[78].

- In 100% of the pension funds, Executive Officers can be removed at any time.[79]

b. Pension funds sponsored by public companies:

- In 14 out of 15 pension funds (93.33%), the members of the Deliberative Council are not removable. 1 out of 15 pension funds (6.66%) allows for members of the Deliberative Council appointed by the sponsors to be removed at any time.
- In 100% of the pension funds, Executive Officers can be removed at any time.

4. Composition

a. Pension funds sponsored by private companies:

- deliberative councils: the average proportion of participants' representatives in deliberative councils is 37.47%, therefore the average proportion of sponsors' representatives is 62.53%.
- executive officers: the average proportion of participants' representatives in executive officers varies between 5% and 9.9%, therefore the average proportion of sponsors' representatives varies between 90.1% and 95%.
    i. 8 out of 15 pension funds (53.33%) have 100% of their Executive Officers appointed directly by the sponsor.

[78] Since Brazilian law does not prohibit the removal of members of the Deliberative Council, whenever the by- laws did not state whether it was possible to remove the members of the Deliberative Council at any time or not, it was assumed that it was possible to remove them at any time.
[79] Since Brazilian law does not prohibit the removal of Executive Officers, whenever the by-laws did not state whether it was possible to remove the Executive Officers at any time or not, it was considered that it was possible to remove them at any time.

ii. out of 15 pension funds (26.66%) have 100% of their Executive Officers appointed by the Deliberative Council.

iii. 3 out of 15 pension funds (20%) have 25% of their Executive Officers appointed directly by the participants and 75% of their Executive Officers appointed directly by the sponsor.

b. Pension funds sponsored by public companies:

- deliberative councils: the average proportion of participants' representatives in Deliberative Councils is 50%, therefore the average proportion of sponsors' representatives is 50%.
- executive officers: the proportion of participants' representatives in the executive officers varies between 7.77% and 41.11%, therefore the average proportion of sponsors' representatives varies between 58.88% and 95.55%.

5. *Other Observations in Relation to the Information Collected*

- Virtually all the pension funds of the sample offered both defined contribution and defined benefit plans, and the vast majority offered, in addition, hybrid plans comprised partially by a defined contribution and partially by defined benefit.
- All the pension funds are also sponsors of the pension funds; this means that the employees of the pension funds are also its participants.

APPENDIX II

REPRESENTATIVENESS SHEET

1. Important Figures

- Total of beneficiaries of pension funds in Brazil: 2,388,646.[80]
- Total of pension funds in Brazil: 358 entities in July 2004.[81]
- Pension funds sponsored by private entities are responsible for approximately 60.06% of this number and pension funds sponsored by public entities are responsible for approximately 39.93% of the total amount of beneficiaries.
- Total of the investment assets of pension funds in Brazil: R$247,935,501,903.75.[82]
- Pension funds sponsored by private entities are responsible for roughly 36. 8% of this number and pension funds sponsored by public entities are responsible for approximately 63. 2% of the total amount of investment assets.

2. Funds Sponsored by Private Entities

- Representativeness of the sub-sample in relation to beneficiaries: 15.21%
- Representativeness of the sub-sample in relation to the amount of investment assets: 20.43%

[80] Source: Ranking das EFPC por População Total - Posição em 28 de janeiro de 2005, *avaliable at* http://www.previdencia.gov.br/spc/docs/ranking_EFPCs_por_populacao_28_01_05.pdf.
[81] MINISTÉRIO DA PREVIDENCIA SOCIAL, *supra* note 3, 48.
[82] Source: Ranking de Investimentos das EFPC - Posição em 28 de janeiro de 2005, *avaliable at* http://www.previdencia.gov.br/spc/docs/ranking_de_Invest_EFPCs_em_28_01_05.pdf.

3. Funds Sponsored by Public Entities

- Representativeness of the sub-sample in relation to beneficiaries: 24.67%
- Representativeness of the sub-sample in relation to the investment assets: 55.69%

4. Representativeness of the Full Sample

- Representativeness of the sample in relation to beneficiaries: 39.88%
- Representativeness of the sample in relation to the investment assets: 76.13%

5. Representativeness of Each Sub-Sample in Relation to the Full Sample

- Pension funds sponsored by private entities
    - Representativeness of the sub-sample in relation to the full sample regarding participants: 38.13%
    - Representativeness of the sub-sample in relation to the full sample regarding investment assets: 26.87%
- Pension funds sponsored by private entities
    - Representativeness of the sub-sample in relation to the full sample regarding participants: 61.86%
    - Representativeness of the sub-sample in relation to the full sample regarding investment assets: 73.15%

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