CVM Instruction 408 of August 18, 2004

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Provides for inclusion of Special Purpose Companies (SPCs) in the consolidated accounting statements of publicly-held companies.

The Chairman of the Securities Commission of Brazil – CVM hereby announces that the CVM Board, at a meeting held on this date, pursuant to articles 8, I and 22, paragraph 1, II and IV of Law No. 6385 of December 7, 1976, and to articles 177, paragraph 3 and 249 of Law No. 6404 of December 15, 1976, has issued the following Instruction:

Article 1. For purposes of the provisions of CVM Instruction No. 247 of March 27, 1996, the consolidated accounting statements of publicly-held companies shall encompass, in addition to controlled companies, the Special Purpose Companies (SPCs) jointly or severally considered, whenever their core relations with the reporting publicly-held company indicate that the activities of said special purpose companies are directly or indirectly controlled, whether jointly or severally, by the publicly-held company.

Sole Paragraph. Control indicators of the SPC activities are held to occur when said activities are conducted on behalf of the publicly-held company or substantially in light of its specific operational needs, provided that in an alternative manner, directly or indirectly:

I – the publicly-held company has the decision-making power or sufficient rights to obtain a majority of the benefits from the SPC activities, and therefore may be exposed to risks arising from said activities; or

II – the publicly-held company is exposed to most of the risks relating to ownership of the SPC or of its assets.

Article 2. The ownership interest in the SPC included in the consolidation shall be appraised by the equity accounting method, pursuant to CVM Instruction 247/1996.

Sole Paragraph. The adjustments arising from changes produced by the equity method under this article shall not constitute adjustments of previous fiscal years, and shall be registered as provided for in Instruction 247/1996.

Article 3. In a note to its consolidated accounting statements, the publicly-held company shall disclose not only the information required under articles 20 and 31 of CVM Instruction 247/1996, to the extent applicable, but also the following information:

I – nature, purpose and activities of the SPC;

II – the type of its relationship with the SPC;

III – the kind of exposure to losses arising from said relationship with the SPC; and

IV – the type and value of consolidated assets that have been offered as security for the SPC obligations.

Article 4. A publicly-held company that has sufficient rights to obtain substantial benefits from the SPC activities, that is, which is also exposed to substantial risks relating to the SPC activities or to the SPC assets, without, however, falling under the provisions of article 1 hereof, shall disclose the following information in an explanatory note:

I – the nature, purpose and activities of the SPC;

II – the kind of its relationship with the SPC;

III - the kind of exposure to losses arising from said relationship with the SPC;

IV – the particulars of the primary beneficiary or group of primary beneficiaries of the SPC activities; and

V – the information required in article 20 of CVM Instruction 247/1996, to the extent applicable.

Sole Paragraph. For the purposes of the main section of this article, entities with financial and operational leeway, such as clients and suppliers of the publicly-held company, without prejudice to the provisions of CVM Resolution No. 26 of February 5, 1986, shall not be considered as SPCs.

Article 5. The publicly-held companies whose fiscal year closes on or before December 31, 2004 shall disclose at least the following information in a note to the corresponding accounting statements:

I – name, nature, purpose and activities performed by the SPC;

II – interest in the SPC equity and results;

III – nature of its relationship with the SPC and the type of loss exposure, if any, arising from said relationship;

IV – amount and nature of credits, obligations, income and expenses between the company and the SPC, assets transferred by the company, and rights to use the SPC assets or services;

V – total value of assets, liabilities and equity of the SPC;

VI – *aval* guarantees, mortgages or other guarantees granted to the SPC; and

VII – identification of the major beneficiary or group of major beneficiaries of the SPC activities, in the event set forth in article 4.

Article 6. With due regard for the provisions of the preceding article, the publicly-held companies shall observe the remaining provisions of this Instruction in the consolidated accounting statements for the fiscal years ended as from January 1, 2005, with immediate application thereof being optional.

Sole Paragraph. For purposes of comparability, the consolidated accounting statements of the previous fiscal year shall be disclosed already including the SPCs existing at the time said statements were originally prepared.

Article 7. This Instruction comes into force on the date of its publication in the Official Gazette of the Federal Executive.

MARCELO FERNANDEZ TRINDADE

Chairman

ATTACHMENT

NOTES

Ref. CVM Instruction 408, which provides for inclusion of Special Purpose Companies – SPCs in the consolidated accounting statements of publicly-held companies

1) Introduction to SPCs

An entity may be organized for a specific and well-set purpose, such as to engage in a leasing transaction; to develop R&D and gas, thermal or electric power exploitation activities; or to engage in securitization of financial assets. Such Special Purpose Company – SPC may be organized in the form of an enterprise, foundation, company or other atypical corporate form. SPCs are usually organized with legal, statutory or contractual provisions imposing strict limits to their decision-making process.

These provisions usually specify that the policy directing the ongoing activities of the SPCs cannot be changed other than, maybe, by its grantor or sponsor, that is, they operate by means of a mechanism called autopilot.

The sponsor or entity in whose benefit an SPC was established may transfer assets to the SPC, and obtain the right to perform services or use the assets owned thereby, whereas other parties ("providers of funds") may contribute the funds necessary to support the SPC, against a rent, fee or entitlement to results. A company that has transactions with an SPC (usually its grantor or sponsor) may substantially control it.

The organization of an SPC is usually intended to take advantage of funding opportunities upon segregation of specific risks of assets and activities from the overall risks inherent to the company favored by such organization. An entitlement to resulting benefits may, for example, materialize as a debt instrument; equity instrument; participation rights; residual participations; or lease.

Some entitlements to these benefits may simply provide the holder thereof with a fixed or stated return fee, whereas others may give the holder a right or access to other future economic benefits originating from the SPC activities. In most cases, the grantor or sponsor retains a substantial interest in the benefits originating from the SPC activities, although it may hold a negligible or no stake in the SPC net equity.

2) The duty of consolidating

Article 249, sole paragraph (a) of the Corporation Law vests the CVM with powers to issue rules on the inclusion, in the consolidated accounting statements of publicly-held companies, of non-controlled entities that are administratively and financially dependent on these reporting companies. Moreover, pursuant to the Basic Accounting Framework approved by CVM Resolution 29/86, as well as to the Basic Accounting Principles approved by Federal Accounting Council (CFC) Resolution 750/93, the transactions and other events must be posted according to their economic essence and reality, not only for their legal format. The Basic Framework states that an "entity, from an organizational perspective, may be viewed as a person or group of persons exercising control over income, expenses, investments and distributions." This means control over the activities and ensuing benefits, and such control may be exercised either by one single entity or a group of entities, without necessarily having a share control or even any ownership interest in the corporate capital.

This rule is not intended to restrict or make SPCs unfeasible, but to improve disclosure of financial information about publicly-held companies. According to the CVM, if a

company exercises *de facto* control over an SPC (irrespective of existence of an ownership interest), then the assets, liabilities and results arising from the activities of said entity must be included in the consolidated accounting statements of the controlling company.

Moreover, for consolidated reporting purposes, an ownership interest (if any) must be appraised by the equity method, and the results obtained by the SPC must be accounted for by the controlling entity in the same fiscal year on an accrual basis.

3) Grounds for use of the equity method and consolidated reporting

The objective of producing satisfactory accounting information for capital market players relies on the ability of the publicly-held company to prepare accounting statements evidencing the quality of its results and financial condition, besides allowing for evaluation of the performance of its management as regards the funds entrusted thereto. The process of consolidating and disclosing accounting information and of applying the equity accounting method are important steps towards the disclosure of quality accounting information, by reflecting all economic relations that may have a material bearing on the company's performance (see, also, Paragraph 8 of the Standing Interpretations Committee - SIC – 12).

The consolidation of accounting information is currently regulated by CVM Instruction 247/96, which requires full consolidation of controlled entities or proportional consolidation of entities under common control. For the consolidation to be required, there must be a corporate bond between the controlling entity and its controlled companies. However, transactions involving the SPC have become increasingly common, and the focus on consolidation based exclusively upon voting capital has sometimes proved to be inefficient in identifying the effective control over an economic activity. CVM Instruction 247 does not provide specific guidance as to the obligation of including said entities in the consolidated accounting statements; thus, a specific rule on the matter is necessary.

Currently, we have faced several situations in which an entity holds *de facto* control over the activities and benefits of another entity, without necessarily entailing a direct or indirect relation or ownership interest. In light of such exercise of control, risks are also taken. As a result, certain businesses "controlled" by publicly-held companies may not be evidenced in the consolidated accounting statements of the latter, oftentimes substantially affecting the information on the financial and equity conditions of the company as a whole. Consequently, assets, liabilities, income and expenses may end up not being reported in the relevant accounting statements.

Therefore, full or proportional consolidation applies to an SPC when the essence of the relation between the publicly-held company and the SPC indicates that the latter is jointly or severally economically controlled by the publicly-held company.

4) Control over an SPC

Within the context of an SPC, control may come up by preestablishing the SPC's activities (operating under a kind of an "autopilot") or otherwise. CVM Instruction 247 lists a number of circumstances resulting in economic control, even when an entity holds less than half of the shares entailing a voting power in another entity. Likewise, this type of control may exist even when an entity has little or no stake at all in the SPC. All pertinent factors must be taken into consideration when determining whether a "control" is held to occur in each case.

It is worth stressing, however, that this concept of "economic control" set forth in said Instruction (which is adopted to defend consolidation as a means of submitting the best accounting information possible) differs from the concept of "control" under corporate law and implies no applicability of the disregard doctrine.

However, economic or financial dependence of an entity on a publicly-held company (such as the relations between suppliers and an important client) does not imply a "control" in and of itself.

Details and examples of the tests to determine whether a publicly-held company has economic control over an SPC, and when the latter should thus be included in consolidated accounting statements, are given below.

However, this is not intended to serve as a complete listing of all conditions that would trigger the consolidation of SPC results.

SPC Control Indicators

a. Activities

The SPC activities, in their essence, are being conducted in favor of the publicly-held company that directly or indirectly established the SPC according to its specific entrepreneurial needs. As examples we have:

- the SPC is primarily structured to provide a source of long-term capital or funding to support ongoing (core or central) operations of the publicly-held company; or

- the SPC provides an array of goods or services in line with the operations of the publicly-held company, which would have to be provided by the latter itself if the SPC did not exist.

b. Decision-making

The publicly-held company, in its essence, has powers to make decisions to control or to obtain future control of the SPC or of its assets, including certain decision-making powers originated after the SPC is established. Said powers may have been delegated by creating the "autopilot" mechanism, for example:

- the publicly-held company has powers to unilaterally wind up the SPC;

- the publicly-held company has powers to amend the SPC bylaws or articles of association; or

- the publicly-held company has veto powers over proposed amendments to the SPC bylaws or articles of association.

c. Benefits

The publicly-held company, in its essence, is entitled to most benefits arising from the SPC activities under the bylaws or based on agreement, authorization or any other business arrangement. Said rights to the SPC benefits may serve as control indicators when in favor of an entity that usually does business with an SPC, and the entity continues to receive these benefits originating from financial performance of the SPC, for example:

- the company is entitled to most economic benefits distributed by the SPC, in the form of future cash inflow, profits, net assets or other economic benefits; or

- the company is entitled to most residual benefits in outstanding distributions or payments programmed at the SPC.

d. Risks

A control indication can be obtained by assessing the risks of each party doing business with an SPC. The publicly-held company usually gives direct or indirect assurance of a return or credit protection (via SPC) to foreign investors that substantially provide funds for financing the SPC. As a result of such assurance, the publicly-held company retains residual or ownership risks, whereas the investors' exposure to losses and gains is limited, for example:

- capital providers have no relevant interest in the SPC net assets;

- capital providers are not entitled to the future benefits of the SPC;

- capital providers are not substantially exposed to the risks inherent to underlying net assets or the SPC transactions; or

- capital providers receive an amount equivalent to creditor's yield under a debt or equity instrument.

5) Disclosure

Some companies have been preparing and releasing, on their own initiative, quarterly consolidated accounting statements. In this case, these accounting statements must also include the SPCs as stipulated in the concepts and determinations contained in this Instruction and Note. As for compulsory disclosure on the SPC not included in the consolidation, when this may have a relevant impact on the publicly-held company (art. 4), one should take into account that the relevance of information is influenced by its nature and materiality, irrespective of the suitability of such disclosure. In many cases, 'materiality' relates to figures, usually ratios to certain items in the accounting statements (net income, net equity, assets, liabilities, etc.). The nature of the information is usually related to an evaluation of the undertaking, irrespective of the amount involved. Anyway, the information that – if not disclosed or otherwise misstated – may influence the economic decision-making process of a user of accounting statements, thus leading him to make a substantial mistake with regard to his evaluation of the undertaking or its prospects, must be considered relevant.

6) Effectiveness

The obligation to fully apply this rule will only occur as from the 2005 consolidated statements, so the publicly-held companies will have plenty of time to conform to it. However, this Instruction may be adopted forthwith, in which case the obligation of disclosure under article 5 is not valid.

7) Applicability of the rule

The international accounting standards consider that the accounting statements are fair when said standards are properly applied to nearly all circumstances.

However, in extremely rare cases, application of a certain requirement may result in unfair or even misleading accounting statements in relation to the principles that guide them. This may be the case when automatic application of the procedures set forth in this Instruction is not in line with the concepts contained therein, thus translating into incorrect statements. However, an exception to the application of this Instruction is not justifiable only because another type of disclosure could have been adopted, such as explanatory notes (in this regard, please refer to paragraphs 10 and 16 of IAS 1). Within this context, in the exceptional circumstances where application of this rule is clearly inadequate, the company may seek exclusion of the SPC from its consolidated accounting statements by means of a substantiated request, as it is currently made in relation to other consolidation procedures, including when such inclusion would be negligible.

The judgment effort on the part of the management of a company and its auditors to whether or not include an SPC shall be based on compliance with the principles underlying the set of accounting statements and on the general objective of providing useful information. For such reason, the economic essence shall prevail over the legal format so that the integrity of the consolidated accounting information is maintained.

It is worth mentioning that this rule is in line with the CVM objectives to harmonize Brazilian accounting practices with international accounting standards, *i.e.*, in this specific case, the rulings issued by the International Accounting Standard Board –IASB (SIC No. 12 of November 1999) and by the Financial Accounting Standard Board – FASB (FASB Interpretation No. 46 of January 2003).

Finally, this Note is an integral part of the Instruction, and the additional concepts and instructions contained herein shall be complied with by publicly-held companies.

MARCELO FERNANDEZ TRINDADE

Chairman