

Michigan Business & Entrepreneurial Law Review

Volume 2 | Issue 1

2012

Private Equity in Brazil: Industry Overview and Regulatory Environment

Shannon Guy
University of Michigan Law School

Follow this and additional works at: <https://repository.law.umich.edu/mbelr>



Part of the [Banking and Finance Law Commons](#), [Business Organizations Law Commons](#), and the [Comparative and Foreign Law Commons](#)

Recommended Citation

Shannon Guy, *Private Equity in Brazil: Industry Overview and Regulatory Environment*, 2 MICH. J. PRIVATE EQUITY & VENTURE CAPITAL L. 155 (2012).

<https://doi.org/10.36639/mbelr.2.1.private>

This Note is brought to you for free and open access by the Journals at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Business & Entrepreneurial Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

NOTE

PRIVATE EQUITY IN BRAZIL: INDUSTRY OVERVIEW AND REGULATORY ENVIRONMENT

Shannon Guy*

I. INTRODUCTION	155
II. INTRODUCTION TO BRAZIL'S PRIVATE EQUITY INDUSTRY	156
III. BRAZIL'S REGULATORY FRAMEWORK FOR PRIVATE EQUITY INVESTMENTS	162
IV. CONCLUSION	192

I. INTRODUCTION

Brazil is currently one of the most attractive markets in the world for private equity investments. In 2010, 36 percent of private equity investors surveyed by the Emerging Markets Private Equity Association and Coller Capital claimed that they planned to expand to Brazil in 2011.¹ Then, in 2011, Brazil passed China as the single most attractive emerging market for private equity investments, according to the same survey.² As Brazil's economy matures, its private equity industry has ample room to continue growing, as evidenced by its relative size in comparison with more mature markets. In 2009, private equity and venture capital commitments represented 2.33 percent of GDP in Brazil, as compared to 3.7 percent of GDP in the United States and 4.7 percent in the United Kingdom.³ With so much attention being paid to Brazil's private equity industry, a description of the industry's growth, its key regulators and regulations, and a critical assessment of regulatory policies are timely.

The overall goal of this note is to paint a picture of the current state of the private equity industry in Brazil and the existing regulations which must be obeyed to participate as a private equity investor. Part II of this note provides a brief history of the private equity industry in Brazil, dis-

* The author is a third-year law student at the University of Michigan Law School. The author would like to thank Professor Michael S. Barr, Professor Vikramaditya S. Khanna, Ligia Bernardo, and Arthur Rodrigues for their valuable advice in connection with this Note.

1. Jason Mitchell, *Brazil's Stellar Returns Attract Global Private Equity Players*, INSTITUTIONAL INVESTOR (Mar. 15, 2011), <http://www.institutionalinvestor.com/Article/2785726/Brazils-Stellar-Returns-Attract-Global-Private-Equity-Players.html?ArticleId=2785726>.

2. See *Brazil Overtakes China as Private Equity Favourite*, LONDON EVENING STANDARD (Apr. 18, 2011), <http://www.thisislondon.co.uk/business/brazil-overtakes-china-as-private-equity-favourite-6393270.html>.

3. Antonio Gledson De Carvalho et al., *Private Equity and Venture Capital in Brazil: an Analysis of its Recent Evolution 5* (Getulio Vargas Foundation, Working Paper No. G24, 2012), available at <http://ssrn.com/abstract=1996729>.

cusses recent investor interest in the growing area, and introduces the main regulatory bodies in Brazil. Part III explains several specific rules that govern a private equity investment by breaking down the “life” of a private equity investment into four stages: (1) setting up the private equity fund, (2) investing in a targeted company, (3) managing the targeted company, and (4) exiting the investment. At each of these stages, the focus is on explaining the general ground rules that a private equity investor must abide by, with the goal of introducing practitioners to the regulations governing an investment in Brazil throughout the investment’s life cycle. In a complementary note, which will be published in Issue 2 of this Journal, I will build on this introduction to Brazil’s private equity industry and main regulators and provide a critical analysis of the underlying policy choices inherent in Brazil’s regulatory regime, and provide modest suggestions for future reforms.

II. INTRODUCTION TO BRAZIL’S PRIVATE EQUITY INDUSTRY

This section introduces Brazil’s industry for private equity investments and summarizes recent investor interest in the country. The goal of this section is to familiarize the reader with the size and scope of the industry and to introduce key macro-economic and regulatory changes adopted by the Brazilian Government that have allowed it to blossom. This section also introduces the key regulators that play a role in setting rules that govern private equity investments in Brazil. The substantive regulations that govern investments are explored in Part III.

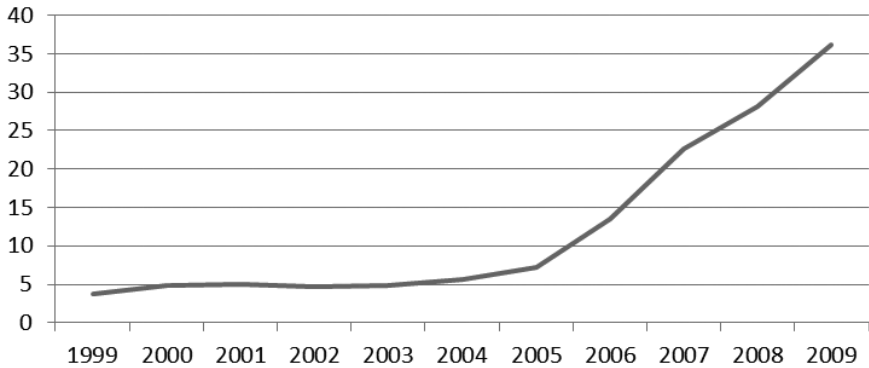
A. *Growth of the Brazilian Private Equity Industry*

The Brazilian private equity industry⁴ was born amid market-oriented reforms of the mid-1990s, grew in fits and starts during its first fifteen years, and has experienced a rapid, explosive expansion in the past ten years. The size of the private equity industry in a given country may be measured by capital commitments, the amount of money passed through a private equity vehicle and allocated to a company in a private equity transaction. The following graph in Table 1 (made using data compiled by De Carvalho et al.,⁵) demonstrates the growth of capital commitments in Brazil.

4. The private equity investment process entails raising funds from qualified investors, organizing a private equity investment vehicle to hold those funds, choosing target (portfolio) companies to receive strategic investments, exercising influence over those companies to make them more valuable, and then selling the original investment for a profit. Private equity frequently refers to investments made in already existing companies in the mid-to-later stages of growth. Venture Capital is a type of private equity investment usually focused on new, high-growth companies in their early stages. Accordingly, venture capitalists may focus on “seed” or “startup” funding, and private equity investors may focus on “mezzanine,” or “growth,” funding. For purposes of this note, these two categories of investment are discussed together as part of the overall Brazilian private equity industry.

5. De Carvalho et al., *supra* note 3.

TABLE 1: BRAZILIAN PRIVATE EQUITY CAPITAL COMMITMENTS
1999-2009 (BILLIONS OF USD)



Before the mid-1990s, there was virtually no private equity industry in Brazil. Then, in 1994, the Brazilian Government enacted the *Plano Real*, a free-market oriented comprehensive governmental reform aimed at stabilizing the currency and encouraging investment in Brazil. The reforms imposed by the *Plano Real* were mostly economic, like pegging the Brazilian *real* to the dollar, and included measures aimed at capital liberalization and the privatization of several state-owned companies. These reforms succeeded in encouraging investment, and Brazil received its first wave of intrepid private equity investments in the early 1990s.⁶

Initial international investor enthusiasm for Brazilian private equity was short-lived. In 1999, Brazil experienced macroeconomic shocks related to the Asian and Russian financial crises. The *real* was devalued in 1999, which severely affected the performance of dollar-denominated investments in Brazil. Due to this economic uncertainty, foreign investors by and large withdrew their investments from the country by the turn of the century.⁷

The period between 1999 and 2004 was a time of gradual growth in the Brazilian private equity industry. While most foreign investors had left, local players continued to make small investments in the tens of millions of dollars in medium-sized companies. According to Ocrama, an alternative investment fund that invests in private equity funds, local players were able to generate attractive gross returns during this time, averaging 30 percent per year.⁸ With the rise of these successful local players, the private equity industry in Brazil slowly expanded. As demonstrated by the graph above, commitments grew at 9 percent per year between 1999-2004, from \$3.7 billion to \$5.6 billion. Since 2004, the Brazilian private equity indus-

6. Mitchell, *supra* note 1.

7. *Id.*

8. *Id.* As mentioned in Part III, there is little independent data on the size and scope of private equity fund deals—unless these deals are disclosed to the public—so information generally comes from “insiders”.

try has experienced an explosive growth spurt, which only slowed down briefly during the recent financial crisis. Capital commitments spiked between 2004 and 2009 at a growth rate of nearly 50 percent per year, reaching \$36.1 billion by 2009.⁹ While investment in Brazil slowed during the recent financial crisis, as demonstrated by a decrease in Brazil-targeted fundraising, it has since picked back up.¹⁰ According to the Emerging Markets Private Equity Association, Brazil-targeted fundraising reached \$3.6 billion in 2008, dipped down to approximately \$0.5 billion in 2009 (alongside a global slowdown associated with the recession), but completely recovered by 2010, reaching \$4.6 billion and surpassing the 2008 high.¹¹ In 2011, Brazil-targeted fundraising had another record-setting year, reaching \$7.1 billion.¹² This trend demonstrates that private equity investors remain interested in raising funds dedicated to investment in Brazil, and the market will likely continue growing, even in the post-financial crisis environment.

The number of private equity deals conducted each year, in absolute numbers, also increased during the relevant time period. According to a survey written by Michael Prahel et al. and published by the INSEAD Global Private Equity Initiative (GPEI) with support from Price-waterhouseCoopers, the number of private equity deals in Brazil has steadily increased between 2006 and September 2010, from 63 private equity deals in 2006 to 243 by September of 2010.¹³ By 2011, more than 550 Brazilian companies had received venture capital or private equity investments.¹⁴ This data demonstrates that Brazilian investment is not only increasing, but that these investment funds are being dispersed between an increasing number of different companies, rather than concentrated in the hands of just a few power players.

The reasons for the explosive growth of Brazil's private equity industry since 2004 are diverse, and a detailed discussion of each is beyond the scope of this note. Here, I highlight several important macroeconomic and regulatory factors which help explain the period of rapid growth in Brazil's private equity industry. Most importantly, Brazil's stabilization of its inflation rate has been a crucial component for this growth.¹⁵ While Brazil's interest rate was historically high, since 1996 Brazil has generally

9. De Carvalho et al., *supra* note 3.

10. See Ernst & Young, *Private Equity in Brazil: Ready for its Moment in the Sun* ERNST & YOUNG 6-13 (2010), [http://www.ey.com/Publication/vwLUAssets/Private_Equity_in_Brazil/\\$FILE/EY_Private_Equity_in_Brazil.pdf](http://www.ey.com/Publication/vwLUAssets/Private_Equity_in_Brazil/$FILE/EY_Private_Equity_in_Brazil.pdf).

11. Mitchell, *supra* note 1.

12. *Full-Year 2011 EM PE Industry Statistics*, EMERGING MARKETS PRIVATE EQUITY ASSOCIATION (Mar. 16, 2012), <http://www.empea.org/research/data-and-statistics/full-year-2011-em-pe-industry-statistics>.

13. Michael Prahel et al., *Brazilian Private Equity: Moving Centre Stage 4* (INSEAD, Working Paper No. 2011/74/DS, 2011), <http://www.insead.edu/facultyresearch/research/doc.cfm?did=48210>.

14. Mitchell, *supra* note 1.

15. De Carvalho et al., *supra* note 3, at 3.

kept rates below 10 percent, and closer to 5 percent (with the exception of a brief spike in inflation in 2003). Reigning in inflation is important to private equity investors because it demonstrates macroeconomic stability and assures them that their money will not depreciate in value due to macroeconomic factors.

De Carvalho et al. attribute the achievement of a stable inflation rate to the actual implementation of the reforms introduced in the 1994 *Plano Real*, discussed earlier.¹⁶ De Carvalho et al. also credit the Brazilian Government with publicly reaffirming its commitment to monetary stability as key to stabilization of the macro-economy, particularly when investors feared Brazil might veer left during the early years Lula da Silva's presidency (2003 and 2004).¹⁷ Another important factor in Brazil's achievement of relative macroeconomic stability was the country's achievement of "investment grade" status in 2008.¹⁸ Notably, foreign investments skyrocketed after this upgrade.

Alongside efforts to curb inflation, improvements in income distribution and reductions in poverty led a large number of Brazilians to enjoy increased purchasing power, which likewise increased Brazil's economic prosperity and improved its investment environment.¹⁹ According to the GINI index, which measures the distribution of income among individuals in an economy, Brazil has reduced income inequality over the past several years. While Brazil's GINI co-efficient was 61 in 1990; by 2010, it had been reduced to 54.7.²⁰

Major regulatory reforms also contributed to the growth of Brazil's private equity industry. First, in 2003, the Brazilian Government specifically created a special kind of investment vehicle known as *Fundos de Investimento em Participações* ("FIPs"), which allowed for special tax incentives similar to those available under U.S.-style private equity investments and provided significant incentives for investors to invest in private equity funds in Brazil.²¹ The availability of this special type of vehicle facilitated additional investments in the country and demonstrated the Brazilian Government's commitment to encouraging private equity. Second, Brazil significantly improved corporate governance by reforming its main domestic stock market, BOVESPA. BOVESPA created a voluntary listing segment, the *Novo Mercado*, "New Market," which gave companies the option to list with more stringent corporate governance standards, or maintain the status quo, and list on other segments. Companies, by and large, began to list on the Novo Mercado segment, paving the way for several successful IPOs, which are important to private equity investors

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.* at 5.

20. Gini Index Data, THE WORLD BANK, available at <http://data.worldbank.org/indicator/SI.POV.GINI>

21. *See id.* at 8.

insofar as they represent a viable exit opportunity for the private equity investment. Third, Brazil's decision in 2009 to allow pension funds to invest up to 20 percent of fund capital in private equity vehicles allowed these funds to become an important class of institutional investors, and provided private equity funds with an influx of available capital to make investments.

B. Key Regulators in Brazil's Private Equity Industry

This section introduces the regulatory bodies that set the rules for private equity actors in Brazil. These regulatory bodies include the Brazilian Government's Securities and Exchange Commission (*Commissao de Valores Moviliarios*), self-regulatory agencies such as the Brazilian Association of Financial and Capital Markets Entities ("ANBIMA"), and the São Paulo Stock Exchange ("BOVESPA").

The Brazilian Securities and Exchange Commission ("CVM") is the main national regulator for private equity funds. The CVM's general goal is to protect capital markets by releasing broad regulations for investment funds. The CVM's regulatory power includes issuing binding instructions and deliberations that affect private equity; but, notably, this activity is not the agency's main focus. The CVM articulates its mission as such:

To secure the efficient and regular monitoring of the stock exchanges and over-the-counter markets, protect the holders of securities against the illegal actions of administrators and controlling shareholders, to attempt to avoid or restrain the fraud, the creation of unfair market conditions, or price-fixing, to assure public access to information related to negotiated securities and the companies that emitted them, to secure the observation of equitable commercial practices in the securities market, to stimulate saving, and to promote the expansion and efficient functioning of the stock market.²²

The key thing to note about the CVM's mission is that it is primarily focused on regulating *securities* and overseeing the stock market. The "quotas" that are issued to private equity fund holders are *not* considered securities under Brazilian law because they are private placements sold to qualified investors.²³

22. *Main Objectives*, SEC. AND EXCH. COMM'N OF BRAZIL, <http://www.cvm.gov.br/ingl/indexing.asp> (last visited Nov. 16, 2012).

23. Up until 2001, Brazilian law employed a restrictive concept of what constituted a security. Law no. 6,385/76, which created the CVM in 1976, provided a comprehensive list of "securities" that could be updated only by rule of the National Monetary Council. "Private equity investments," were not on the CVM's enumerated list of securities, nor were funds that generally invested in companies that were not publicly traded. Accordingly, both went unregulated by the CVM. By contrast, the quotas of investment funds that invested in public companies were considered securities, and were regulated by the CVM. The definition of security changed in 2001 when Law No. 10,303/01 amended 6,385/76 and established that the existence of a public offering of equity or debt becomes the determining factor in the qualification of a bond or contract as a security. Under this definition, private equity funds do not meet the definition of "securities" because they are limited to qualified investors. See Marcelo Trindade, *Strategic Challenges for the Investment Fund Industry* 11 (March 5, 2012),

Even though private equity funds are not considered securities under the CVM's primary area of concern they are, nonetheless, folded into the CVM's regulatory responsibilities. CVM Instruction 391/03 regulates the establishment, functioning, and administration of the most popular form of private equity fund in Brazil, the FIP.²⁴ Other CVM instructions require private equity funds that are organized under different legal rules (such as a holding company) to register with the CVM and to provide information related to the sorts of investments the fund will make.²⁵ Further, the CVM can bring enforcement actions related to investor protection.

Private equity funds are also subject to regulations imposed by self-regulated entities if they are members of certain self-regulatory organizations and when they take their portfolio companies public. Stock exchanges, futures markets, and other above-ground markets are all self-regulated entities in Brazil which generate rules and regulations that firms need to follow during the public offering process. Further, private associations establish voluntary rules that private equity funds must abide by if they wish to retain membership in the association.

A prominent example of a self-regulatory organization is ANBIMA (The Brazilian Association of Financial and Capital Markets Entities), a private association to which many private equity firms belong. ANBIMA is a self-described "voluntary, private regulator" but also "the representative of institutions that act in the financial and capital markets."²⁶ ANBIMA's members include more than 340 commercial banks, investment banks, asset management organizations, broker-dealers, and investment consultants.²⁷ As "regulator" and "representative" ANBIMA wears many hats. The organization produces statistical studies related to capital markets, seeks to promote transparency by releasing daily indexes related to price data and attempts to educate the public about investment decisions. In April 2012, ANBIMA, along with ABVCAP, the Brazilian Association of Private Equity and Venture Capital, released a Code for the Regulation and Best Practices of Private Equity and Venture Capital Funds, which contains rules that member private equity funds of ANBIMA or ABVCAP must follow.²⁸ Notably, this document is gener-

<http://www.cvm.gov.br/port/public/publ/seminario/PAINEL01/Marcelo%20Trindade%20-%20ingles.pdf>.

24. CVM Instruction No. 391, available at <http://www.cvm.gov.br/asp/cvmwww/atos/exiatio.asp?File=\\Inst\\inst391.htm>

25. BUREAU OF ECON., ENERGY, AND BUS. AFFAIRS, U.S. DEP'T. OF STATE, 2011 INVESTMENT CLIMATE STATEMENT – BRAZIL (March 2011), available at <http://www.state.gov/e/eb/rls/othr/ics/2011/157245.htm>.

26. *What is ANBIMA*, ANBIMA, www.anbima.com.br (last visited Oct. 10, 2012).

27. *Id.*

28. *Código ANBIMA de Regulação e Melhores Práticas [Code for the Regulation and Best Practices]*, ANBIMA, (Jan. 18, 2012), <http://portal.anbima.com.br/fundos-de-investimento/regulacao/codigo-de-fundos-de-investimento/Documents/Codigo%20de%20Fundos%20e%20Investimento.pdf> [hereinafter *Code for the Regulation and Best Practices*].

ated in collaboration with publicly-traded companies to regulate the activities of entities that act in the financial and capital markets.²⁹ The rules imposed by ANBIMA's voluntary code are discussed in Part III *infra*.

The Brazilian stock exchange, BOVESPA, also generates rules that may influence private equity activity. If a private equity investment culminates in an initial public offering and wishes to list on the São Paulo Stock Exchange, it will have a choice as to the amount of corporate governance it wishes to adopt, and it will be able to choose among three different trading segments. BOVESPA's specific regulations are discussed in Part III.

III. BRAZIL'S REGULATORY FRAMEWORK FOR PRIVATE EQUITY INVESTMENTS

Part II of this note introduced the Brazilian private equity industry and its main regulators. This part analyzes the actual regulations that govern private equity investments in Brazil throughout the life of the investment. Taking a closer look at the rules, I analyze the life of an investment in four stages: (1) setting up the private equity vehicle; (2) investing in or acquiring the target company; (3) managing the target company; and, (4) exiting the private equity investment. The goal of this part is to focus on the actual rules that govern private equity investments, and evaluate the Brazilian Government's regulatory choices by focusing on whether or not each encourages private equity investment while minimizing risk and arbitrage.

A. *Stage One: Choosing a Private Equity Investment Vehicle*

A private equity investor's general goal in setting up a private equity vehicle is to establish a business entity that allows an investor to invest in companies in ways that allow the investor to influence the company's decisions and increase its value in order to sell the investment for a profit within a certain amount of time (usually at least five years). The first thing a private equity investor needs to do to conduct this investment in Brazil is to establish a private equity fund under Brazilian law and begin collecting money from investors to place in the fund. There are several different private equity investment vehicles available to set up private equity funds that invest in Brazilian companies. This section explains which types of investment may be used, and it describes the trends in fund organizational choices. The section also comments on some of the policy issues raised by the current regulatory regime governing set-up of funds.

To frame the discussion of investment vehicle choice, the pie charts in Table 2 compare which types of investment vehicles were chosen by private equity funds in Brazil during 2004 and 2009. The charts also compare the percentage of total committed capital associated with each type of fund. These charts were prepared using data published by the Brazilian Agency for Industrial Development ("ABDI") in the First and Second

29. *Id.*

Censuses of Private Equity and Venture Capital in Brazil.³⁰ ABDI collected the data used in the charts through voluntary surveys. Nonetheless, the results are extensive since the 239 investment vehicles that responded to the survey in 2009 represented of 94 percent of the total number of investment vehicles in the country and held 97 percent of the total committed capital in the industry.³¹ Since the Brazilian Government does not publish statistics on fund choice, this data appears to be the most comprehensive snapshot of institutional choices that is available. The implications of the findings of these charts are discussed throughout this section of the note.

Also crucial to a discussion of investment vehicle setup is information related to the origin of the funds. In other words, where does the money come from? The following graph in Table 3 from the Getulio Vargas Foundation demonstrates that in 2008, half of the committed capital in Brazil's private equity industry came from funds organized in Brazil, 20 percent came from funds organized in the United States, 16 percent came from funds organized in other places (including tax havens), 13 percent came from funds organized in Europe, and just one percent came from funds organized in other Latin American countries.³² The Getulio Vargas Foundation is currently collecting data to update this survey.

Even though the majority of funds were organized under the laws of Brazil, in 2008, a majority of the money came from outside of Brazil. In June 2008, foreign investors provided 57 percent of all capital commitments.³³ The next largest source of money was Brazilian pension funds, accounting for 24 percent of total committed capital.³⁴ As discussed later, Brazil passed important legislation in 2009, which allowed Brazilian pension funds to invest more money in private equity vehicles. It is likely that the next survey of Brazilian private equity will show an increase in the amount of capital coming from local Brazilian pension funds.

Given these organizational choices, the next part of this note discusses available investment vehicles, factors contributing to choosing each, and policy questions related to setup.

1. Limited Partnerships Organized Under the Laws of Another Country

In the United States, most private equity funds are structured as limited partnerships. This corporate form provides distinct tax advantages for

30. GVcepe of FGV et al., *The Private Equity and Venture Capital Industry: Second Brazilian Census*, GVCEPE 126 (March 2012), <http://gvcepe.com/site/wp-content/uploads/2011/11/The-PEVC-Industry-Second-BR-Census-1ed-Revised-March-2012.pdf> [hereinafter *Second Brazilian Census*].

31. *Id.*

32. GETULIO VARGAS FOUNDATION, OVERVIEW OF THE BRAZILIAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY 16 (2008), available at http://gvcepe.com/site/wp-content/uploads/2008/12/panorama_2008_en.pdf. [hereinafter, OVERVIEW].

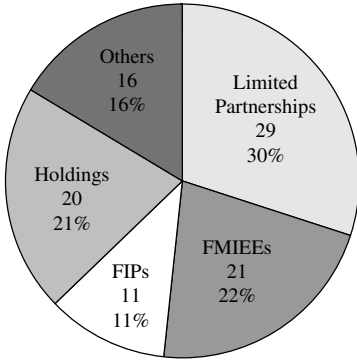
33. *Id.* at 22.

34. *Id.* at 23.

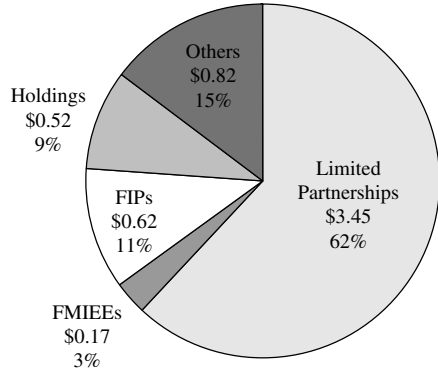
TABLE 2: INVESTMENT VEHICLE CHOICE AND COMMITTED CAPITAL

2004

Legal Structure of PE/VC Investment Vehicles in Brazil

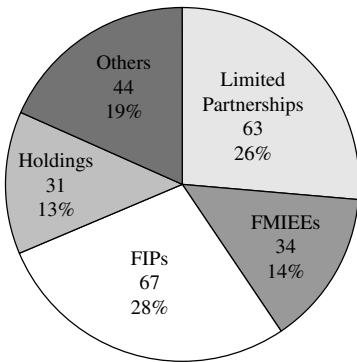


Billions of USD Committed to PE/VC Investment in Brazil

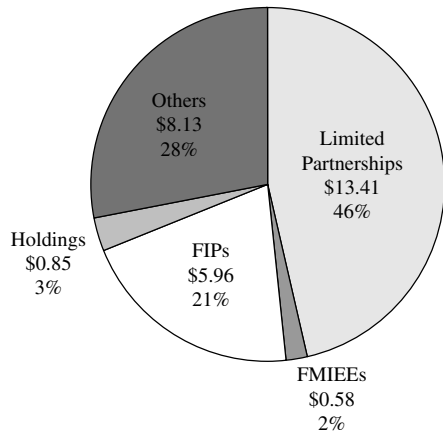


2009

Legal Structure of PE/VC Investment Vehicles in Brazil



Billions of USD Committed to PE/VC Investment in Brazil

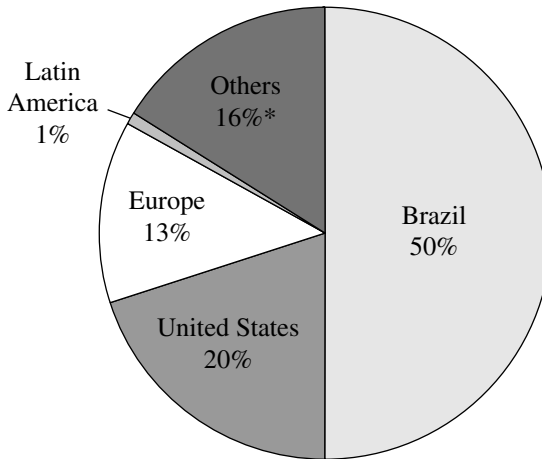


U.S. funds. Notably, the limited partnership form taxes each investor at his own individual income tax rate, as opposed to the higher corporate tax rate.³⁵ In Brazil there is no limited partnership investment vehicle available; however, Brazil allows funds to organize as limited partnerships overseas and then make private equity investments in the Brazilian financial and capital markets.³⁶ If funds wish to operate in this way, funds must

35. De Carvalho et al., *supra* note 3, at 7.

36. *Id.*

TABLE 3: COMMITTED CAPITAL BY PE/VC ORGANIZATION ORIGIN (%)



* Includes Bermuda, the Cayman Islands, the Virgin Islands, and South Africa

OBS: PE/VC organization origin means where it is registered and has its legal headquarters.

register with the Brazilian Central Bank, appoint an attorney-in-fact in Brazil, and designate a financial institution to take responsibility for the fund's investments in the country.³⁷ Frequently, financial institutions serve as both an advisor related to investments, as well as an attorney-in-fact. The attorney-in-fact must enroll at the Brazilian Securities and Exchange Commission, apply for a tax ID, and register each investment with the Central Bank.³⁸

Private equity funds typically choose to organize as a limited partnership overseas when they plan to make a single investment in one Brazilian company and do not intend to raise capital in Brazil.³⁹ It is common for these funds to organize under the laws of Delaware, which has expedited the process of registration and set up.⁴⁰ Choosing to organize a limited partnership abroad allows foreign investors to pick and choose their regulator to establish the fund, and does not require these foreign investors to maintain a physical presence in Brazil (except insofar as they associate with local institutions).

37. CVM Instruction No. 325, available at http://www.cvm.gov.br/ingl/regu/cvm_325.ASP; Central Bank of Brazil Resolution No. 2,689, available at <http://www.cvm.gov.br/ingl/regu/res2689.asp>.

38. *Id.*

39. Carlos Lobo, *Road Map for Private Equity Investments in Brazil*, VEIRANO ADVOGADOS (Jan. 2012), http://www.veirano.com.br/veirano/Portals/0/Road_map_for_private_equity.pdf.

40. Fabio Campos Mello, *Brazil: Private Equity Finds a Home*, INTL. FIN. L. R. (June 1, 2009), available at <http://www.iflr.com/Article/2239218/Brazil-Private-equity-finds-a-home.html>

The above data on preferred investment vehicles in 2004 and 2009, as demonstrated in Table 2's pie-charts, shows that in 2004, limited partnerships organized under the laws of other countries, but with permission to operate in Brazil, were the most frequently used type of investment fund. Investors used this type of vehicle in 30 percent of cases, and such vehicles received by far the most assets, at 62 percent of total committed capital. By 2009, the number of limited partnerships remained high, representing 26 percent of total funds and holding 47 percent of total committed capital, but were second in number to FIPs, which represented 28 percent of total funds and held 21 percent of total committed capital. The decrease in committed capital allocated to limited partnerships is likely due to significant tax benefits associated with FIPs (another organizational form discussed below) and the increased allowance of indirect investment. The fact that limited partnerships remain a common choice likely demonstrates the significant presence of foreign investors interested in making one time, targeted investments in Brazilian companies without the need to raise capital in Brazil.

The availability of limited partnerships structured elsewhere may be a good thing insofar as it opens up Brazilian capital and financial markets to foreign investors who might prefer to organize under the laws of other nations. In this way, it may increase access to money for more Brazilian companies, promoting innovation and growth, which lead to tangible effects in the real economy. On balance, it is possible that the State of Delaware, where many limited partnerships are organized, does a better job than the Brazilian regulators at overseeing the screening process for qualified investors and setting threshold requirements for the organization of private equity funds. This may be due to increased familiarity and specialization as a result of the large number of funds that choose to organize in Delaware. On the other hand, since Brazil allows limited partnerships organized under the laws of any country to access the Brazilian financial and capital markets, if those foreign partnerships follow the procedures described above (registering with the Central Bank and appointing an attorney in fact), the current regulation may risk creating a race to the bottom because Brazil does not inquire about the quality of the home country's regulation. However, since the amount of money involved in private equity investments is large, investors have the incentive to organize in jurisdictions that offer them the most protection. The availability of organizing a private equity fund as a limited partnership organized under the laws of another country is an important reason why many private equity investors are interested in placing their funds in Brazilian private equity investments. Due to the fact that many funds organize in Delaware and because Delaware implements strong oversight into the private equity fund registration process, use of foreign investment vehicles like these perpetuate investment in Brazil because they signal to subsequent investors that the market is populated by stable and non-risky players.

2. Brazilian Private Equity Funds (“FIPs”)

Fundos de Investimento em Participações, or FIPs, are special investment vehicles established specifically for Private Equity funds by the Brazilian Securities and Exchange Commission in 2003.⁴¹ Like U.S. private equity funds, FIPs are structured as “closed funds,” which means that investors cannot redeem their shares at will.⁴² Investors are locked into the investment for the full length of the fund’s term (usually 10 years), making investments in FIPs highly illiquid.⁴³

To set up a private equity fund as a FIP the fund manager must register with three Brazilian institutions. First, the FIP must register its “incorporation acts” at the Registry of Titles and Deeds (*Cartório De Registro De Títulos e Documentos*) in the city where the FIP will have its home office.⁴⁴ In the “incorporation acts,” the fund’s administrator must provide at least: (1) a written statement that he or she accepts his or her appointment and corresponding responsibilities; and, (2) the FIP’s “Regulation,” a document that establishes certain rules regarding the operation and administration of the fund.⁴⁵ As discussed below, FIPs issue “quotas” to investors to fund themselves. The FIP’s Regulation must specifically discuss how the FIP will amortize the quotas it issues to its investors to raise its capital.⁴⁶ Further, the Regulation must specify criteria to determine which publicly-held companies will be eligible to receive its investments.⁴⁷ There is no uniform time frame for FIPs registration, since each city varies widely in the amount of time it takes to process registrations. To gauge how much time to allocate towards registering at the city level, the investor must speak with local counsel. Second, after registering its acts of incorporation, the FIP must enroll at the Brazilian Federal Taxpayer’s Registry of the Ministry of Finance (*Cadastro Nacional de Pessoas Jurídicas* or “CNPJ”). By enrolling at CNPJ the FIP receives a national tax ID number, which allows the federal government to collect taxes from the FIP each year. Notably, the FIP is not subject to Brazil’s Corporate Income Tax, Social Contribution on Profits Tax, Property Participation Program Contribution Tax, or Social Security Financing Contribution tax.⁴⁸ Finally, before the FIP can start operating, the investor must register it with the

41. Latin Am. Private Equity & Venture Capital Ass’n., *Private Equity Tax Benefits of Brazilian FIPs*, LAVCA (Sept. 8, 2009), <http://lavca.org/2009/09/08/private-equity-tax-benefits-of-brazilian-fips/> [hereinafter *Tax Benefits of Brazilian FIPs*].

42. CMV Instruction No. 391/03, available at http://www.cvm.gov.br/ingl/regu/cvm_391.ASP.

43. *Id.*

44. Marcos Rafael Flesch & Marina da Silva Prado, *Private Equity/ Venture Capital Funds in Brazil Fundos de Investimento em Participações-FIPs*, in *INTERNATIONAL BUSINESS TRANSACTIONS WITH BRAZIL* 81, 87 (Beatriz Franco et al. eds., 2008).

45. *Id.*

46. *Id.* at 82.

47. *Id.* at 83.

48. *Tax Benefits of Brazilian FIPs*, *supra* note 41.

CVM. To do so, the FIP must provide the following documents: the FIP's incorporation acts (discussed above); a statement indicating that the FIP has contracted an independent auditor; a statement indicating how many quotas the FIP will issue to raise its funds, and at what price and what cost these quotas represent to the FIP, as well as any other information relevant to quota distribution.⁴⁹ The FIP must also provide any marketing material, including offering memoranda, that the FIP intends to circulate, and any additional information that the FIP will disclose to potential investors.⁵⁰ The marketing material must show risks related to concentration and potential non-liquidity of the portfolio's assets.⁵¹ Finally, the FIP must provide a brief description of the qualifications of the administrator and manager's personnel (if any). If the administrator is not a financial institution, the administrator must include a statement in which he agrees to retain a financial institution to conduct FIP activities. Once these documents are presented at the CVM, the FIP is registered *automatically* and may begin conducting business.⁵² Frequently, the CVM does not conduct a thorough review of the documents, but may require supplemental information after the FIP has already begun its operations. Usually, the request for supplemental information does not interfere with the FIP's functioning.⁵³ According to Veirano Advogados, the process of registering with the CVM usually takes six months.⁵⁴

After going through the necessary registration leg-work, a FIP may begin the fundraising process by issuing "quotas" to qualified investors. Under Article 109 of CVM Instruction No. 409/04, only qualified investors may invest in FIPs quotas, and must make a minimum investment of at least R\$100,000 per investor.⁵⁵ Qualified investors include: financial institutions, insurance and capitalization companies, private pension funds, individuals or corporations who have at least R\$300,000 in other investments, investment funds made up exclusively of qualified investors, portfolio managers and securities consultants licensed by the CVM, and employees or partners of managing institutions (as long as they are authorized by the CVM).⁵⁶ If an investor decides to invest in a FIP he does so through an "investment commitment."

Foreign investors may also choose to invest in a FIP's quotas. Investments in FIPs by foreign investors are considered portfolio investments, which are governed by the National Monetary Council's Resolution No. 2,689/00. Accordingly, these types of investments are frequently called

49. Flesch & Silva Prado, *supra* note 44, at 86-87.

50. *Id.* at 87.

51. *Id.* at 88.

52. *Id.* at 87.

53. *Id.* at 86.

54. Lobo, *supra* note 39.

55. CMV Instruction No. 409/04, available at http://www.cvm.gov.br/ingl/regu/cvm_409.

ASP

56. Flesch & Silva Prado, *supra* note 44, at 82-83.

“2,689 Investments.” Nonresident investors must meet a few requirements before making a 2,689 Investment. First, they must designate at least one representative in Brazil.⁵⁷ Second, they must fill out a form that identifies them and their representative and describes their fiscal resources to make the investment as well as a declaration of intention to do so.⁵⁸ Finally, they must register with the CVM under Regulation No. 325/00.⁵⁹ Upon receipt of the documents required to register at the CVM, the CVM will respond to the investor’s application within 24 hours, signaling a willingness on the part of the Brazilian Government to expedite these types of investments.⁶⁰ Finally, the investor must contract with an entity authorized by the CVM to maintain custody of the negotiated securities.⁶¹ The default rule is that each quota grants a holder a single vote at the investor’s meetings. However, the FIP may define different classes of voting rights attached to different classes of quotas by so specifying in its charter. Doing all of these things completes the set-up of the private equity fund as a FIP, and the fund is ready to begin making investments in target companies.

The FIP structure provides investors with numerous benefits, including favorable tax treatment. The FIP vehicle circumvents Brazil’s lack of a limited partnership form by providing similar tax benefits to those enjoyed by private equity funds structured as limited partnerships in the United States. Investor’s income and capital gains are not typically subject to the same taxes that many Brazilian companies frequently need to pay, including: Brazilian withholding tax, Brazil’s corporate income tax, the “social contribution on profits,” the “profit participation program contribution,” and the “social security financing contribution.”⁶² Further, on December 1, 2011, Brazil eliminated the financial operations tax charged on most foreign investments for FIPs.⁶³ In a statement, the Brazilian Finance Minister announced that the measure was taken to stimulate the Brazilian economy.⁶⁴ FIPs let investors use “tax shields” when funds incur losses and to collect income tax at their own tax rates (as opposed to the higher corporate rate).⁶⁵ Pension funds and other institutional investors may also like to invest in FIPs because they allow capital to be raised by means of

57. *Id.* at 89-90.

58. *Id.*

59. *Id.*

60. CVM Information of Interest to Foreign Investors, available at http://www.cvm.gov.br/port/relinter/ingles/info_invest_estrang-e.asp.

61. CMN Resolution 2,689, available at <http://www.bmfbovespa.com.br/en-us/rules/download/ResolutionCMN2689.pdf>.

62. *Tax Benefits of Brazilian FIPs*, *supra* note 41.

63. Caroline Hornby, *Brazil Eases Entry for Global Investors—Eliminates IOF Tax*, TOTAL ASSET (Dec. 2, 2011), <http://blogs.terrapinn.com/total-asset/2011/12/02/brazil-eases-entry-global-investors-eliminates-iof-tax/>.

64. *Id.*

65. Flesch & Silva Prado, *supra* note 44, at 92.

an offering which is less onerous than the requirements for conducting an IPO.⁶⁶

Managers of private equity funds may prefer the FIP structure because it allows the fund to hold equity ownership in a portfolio company in a way that is similar to a holding company, but in a form that is generally less bureaucratic, less expensive, and generally more tax efficient.⁶⁷ The FIP structure also allows the fund manager to have wide discretion regarding the range of permissible activities undertaken by the fund. For example, the FIP's manager or investors can decide on their own provisions for capital requirements, investment policies, capital call guidelines, amortization structure, and terms of investment.⁶⁸

One disadvantage of choosing to structure a private equity fund as a FIP is that the fund does not provide limited liability for investors as associated with other fund corporate forms.⁶⁹ Even if the fund manager and investors act in the regular course of business, if the FIP acquires a negative net worth, all equity holders will be responsible for covering any negative amounts.⁷⁰ Some investors also see the requirement that investors stay involved in the decision-making process of the portfolio companies, notably through appointment of the board of directors, as problematic.⁷¹

As shown in Table 2, between 2004 and 2009, the number of FIPs and amount of capital committed to them grew significantly. FIPs passed limited partnerships organized outside of Brazil and became the most popular type of investment vehicle by 2009. While FIPs only represented 11 percent of the investment vehicles used in 2004, by 2009, 28 percent of investment vehicles were structured as FIPs. The low level of FIPs in 2004 is likely explained by the fact that they had only come into existence through CVM instruction 391/03 half a year earlier, in June 2003. As discussed above, the tax advantages of the FIP structure likely provide the primary basis for its rise in popularity among private equity investors. More importantly though, FIPs have surpassed limited partnerships due to a September 2009 National Monetary Council resolution increasing the amount of money that Brazilian pension funds could make in alternative investments (including private equity) from 2 percent of their investments to 20 percent.⁷² Just as ERISA in the United States allowed pension funds to make alternative investments in private equity funds, so too this resolution

66. Ricardo C. Veirano & Gustavo Moraes Stolaghi, *Brazilian Regulatory Private Equity Investment Funs-FIPs: Advantages and Benefits*, in INTERNATIONAL BUSINESS TRANSACTIONS WITH BRAZIL 93, 93-94 (Beatriz Franco et al., eds., 2008).

67. *Id.* at 93.

68. *Id.*

69. *Id.*

70. *Id.*

71. The participation of investors in the decision-making process is discussed in more detail in the next section involving "Stage Two" on investing in target companies.

72. *Second Brazilian Census, surpa* note 30, at 129.

liberated a significant source of new capital in the market.⁷³ Today, pension funds provide most of the committed capital in Brazil, and make most of their investments through FIPs.⁷⁴ Other reasons, aside from tax benefits, also contribute to the FIPs' rise in popularity. After the CVM specifically allowed the FIP form, President Lula Da Silva's "blessed" the organizational form by publicly endorsing it at a time when investors feared that the Brazilian Government would "lean left," like many other Latin American nations, undermining free-market-oriented investment conditions.⁷⁵ Specifically, investors were concerned that the previous monetary policies that had been enacted, such as setting inflation targets and primary surplus control, might be abandoned.⁷⁶ The timely creation of the FIP likely signaled to investors that the Brazilian Government intended to encourage, and therefore protect, this type of investment.

The FIP's rise to prominence may be a good thing insofar as it signals that the Brazilian Government was effectively able to create an investment vehicle and have investors use it for its intended purpose. As FIPs become more prevalent, the CVM will likely become more familiar with the way that a private equity fund organized as a FIP should look when it reviews registration material. On the other hand, the prominence of FIPs may lead to the rise of "boiler plate" language that lawyers learn to put in the FIP organizational documents so as not to raise any eyebrows at the CVM, which may make it harder for CVM officials (in their cursory review of registration materials) to detect risks disclosed in the organizational documents. Still, this risk is mitigated by the fact that FIPs must include information specific to their own investment strategy, which is likely the information to which the CVM will pay most attention, due to its potential impact on retail investors.

On balance, the creation of FIPs as an investment vehicle in 2003 is a very positive development for the Brazilian private equity market. These types of funds have been wildly popular and today are the most common form of private equity investment fund organization in Brazil. Because the FIPs insist on quality accounting and corporate governance standards (discussed later), the availability of these funds increases the legitimacy of the Brazilian private equity industry generally and attracts international investment.

3. Mutual Funds Investing in Emerging Companies ("FMIEEs")

Mutual Funds Investing in Emerging Companies (*Fundos Mútuos de Investimento em Empresas Emergentes*, or "FMIEEs") are a special type of investment vehicle designed specifically for venture capital investments

73. *See id.*

74. *Id.* at 143.

75. De Carvalho et al., *supra* note 3, at 3-4.

76. *See* Prahel et al., *supra* note 13, at 5.

and regulated by the CVM's Instruction 209/94.⁷⁷ FMIEEs are closed-end partnerships with 10-year terms, with the possibility for extension of the term. Notably, FMIEE's may only have a maximum of 35 investors and may only invest in corporations that have a net revenue below R\$150 million on the date that the first investment is made.⁷⁸ FMIEE's must undergo a registration process very similar to that of FIPs.

Funds that intend to invest in seed capital, start-up, and expansion generally take advantage of the FMIEE form.⁷⁹ Due to the revenue cap on portfolio companies, FMIEEs are usually unsuitable for funds that intend to invest in companies at more advanced investment stages such as acquisition finance, turnaround finance, or bridge finance.⁸⁰ An investor might choose to set up an emerging companies investment fund because he wishes to structure his portfolio in a way that allows him to make a high risk, potentially high reward investment in a relatively unknown company.

Surprisingly, while FIPs became more popular in recent year, FMIEEs have become significantly less popular, dropping from 22 percent of investment vehicle types used in 2004 to 14 percent in 2009. Capital committed to FMIEEs was minimal in both 2004 (3 percent of total investments) and 2009 (2 percent). The unpopularity of FMIEEs continued into 2010. According to the CVM's 2010 Annual Report, only 29 FMIEE funds were registered on the last day of 2009.⁸¹ In 2010, only one new FMIEE was registered and another was cancelled, leaving the total number of FMIEE funds at the end of 2010 at 29 as well.⁸² By contrast, 258 FIPs were registered by the end of 2009, and 388 FIPs were registered by the end of 2010, resulting in a 130 new registration increase in FIPs as of 2010.

This data may suggest that FIPs are preferred to FMIEEs to finance startups, or that funds deem fewer early stage companies worthy of investment. Many successful Brazilian businesses are family-owned institutions that have worked diligently for many years at developing a brand and a client base. It may be that investors are less impressed at the prospects of newer untested companies in Brazil. Alternatively, it may be that investors simply prefer to use the FIP form, which has no capital limits, to invest in early stage companies.

The availability of FMIEEs as an investment vehicle is a positive development because it encourages investment in early stage organizations, which may have less access to credit and may present higher potential for

77. CVM Instruction No. 209, available at <http://www.cvm.gov.br/asp/cvmwww/atos/exiatio.asp?Tipo=I&File=/inst/inst209.htm>

78. Fabio Campos Mello & Marcus Vinicius Bitencourt, *Brazil: Private Equity Finds a Home*, IFLR (June 1, 2009), <http://www.iflr.com/IssueArticle/2239218/Supplements/Brazil-Private-equity-finds-a-home.html?supplement%E2%80%A6>.

79. *See id.*

80. *Id.*

81. PUB. AFFAIRS & PRESS LIAISON & RESEARCH AND ANALYSIS DEPT, SEC. AND EXCH. COMM'N OF BRAZIL, ANNUAL REPORT 2010, (2010).

82. *Id.*

profit. However, the data suggests that the Brazilian Government has not done enough to foster the kind of regulatory atmosphere that encourages people to take advantage of this type of fund. Since increased innovation and entrepreneurial activity is generally considered a positive factor for macroeconomic growth, a reassessment of FMIEEs' incentive structure may be in order. It may well be time to make FMIEEs as attractive as FIPs, or even provide additional tax breaks for these types of investments.

4. Holding Companies

Private equity funds may also be organized as holding companies, and until recently, this was a fairly popular way of setting up a private equity fund. According to the Getulio Vargas Foundation, holding companies tend to invest in small to medium-sized enterprises, especially venture capital operations.⁸³ For reasons discussed below, these types of funds have become much less common, so discussion of their setup is limited, and a greater focus has been placed on an explanation of why they have decreased in popularity.

Generally, the process for setting up a fund as a holding company includes registering it as either a corporation or a limited liability company. If the holding companies choose to register they are subject to the Brazilian Civil Code's Corporations Law (*Lei das Sociedade Anônima*), and registration of holding companies is governed by Law Number 4131/62. Choosing the Limited Liability Company (*Limitada*) form has the notable advantage of insulating directors from liability for negative equity, except in the case of fraud and related crimes.⁸⁴ Organizational documents include articles of association or bylaws, and possibly a shareholders-investors' agreement.⁸⁵ Law number 8934/94 explains how to register a Limited Liability Company ("LLC") at the Commercial Registry (*Registro Commercial*) of each state. This note will not detail the registration requirements. In general, it takes one month to incorporate a holding company in Brazil, either as a limited liability company or a corporation.⁸⁶ A fund might still choose to set up an LLC because it wishes to take less risk for the performance of the fund, which may signal to investors the riskiness of the investment and allow them to price their risks and rewards investment accordingly.

The data related to investor choice shows that holding companies have become less and less popular as an investment vehicle type and have come to hold less committed capital over the past several years. As demonstrated in the graphs above, 21 percent of private equity investment funds

83. OVERVIEW, *supra* note 32.

84. Ricardo C. Veirano & Gustavo Moraes Stolagli, *Brazilian Regulatory Private Equity Investment Funds-FIPs: Advantages and Benefits*, in INTERNATIONAL BUSINESS TRANSACTIONS WITH BRAZIL 93 (Beatriz Franco et al., eds., 2008).

85. Baker & McKenzie, et al., *Private Equity in Brazil* 7 (Nov. 2008), <http://brazilianchamber.org.uk/sites/default/files/committee-files/privateequityinbrazil1.pdf>.

86. *Id.*

were structured as holding companies in Brazil in 2004 and these held 9 percent of the industry's total committed capital. By 2009, however, holding companies had been somewhat eclipsed by FIPs, and shrunk to 13 percent of the remaining organizational forms, holding only three percent of the industry's committed capital. Two significant disadvantages of the holding company structure as compared with the FIPs likely explain this change. First, profits are taxed at a much higher level than those that are generated under the FIP form.⁸⁷ While the FIP itself never needs to pay a capital gains tax, holding companies must pay a 34 percent capital gains tax for the sale of equity investments held by the holding company.⁸⁸ While Brazilian FIP investors only pay a 15 percent capital gains tax due when they redeem their quotas (this is taxation at the individual income tax level as opposed to the FIP level), Brazilian holding company investors must pay a 20 percent capital gains tax on any capital gains.⁸⁹ International FIP investors that hold less than 40 percent of a FIP's quota pay no capital gains taxes whatsoever, and those who hold more than 40 percent pay a 15 percent capital gains tax, while international investors who invest in holding companies pay a 15 percent capital gains tax no matter how small a stake they hold in the fund.⁹⁰ Second, on top of this unfavorable tax treatment, whereas the FIP form allows write-offs in case of losses, only in limited circumstances may holding companies write off losses due to unsuccessful investments.⁹¹

5. Other Investment Vehicles: Real Estate Funds and Infrastructure Funds

The Brazilian Government has sought to encourage investment in certain industries by providing incentives for investors to create FIPs that invest primarily in one type of company or project. As the graphs in Table 2 illustrate, other investments grew from representing 15 percent of committed capital in 2004 to 28 percent of committed capital in 2009. While there are several different types of "other" investments, two of the most important are highlighted in this section. Private equity investors who seek to make large investments in real estate or infrastructure can take advantage of two special investment vehicles tailored to suit those goals.

The set-up of a real estate fund is essentially the same procedure as that used to set up a FIP, but with the additional requirement that at least 90% of the real estate fund's investments be made in real-estate. If an investor knows that he plans to invest primarily in real estate, this type of fund provides some tax advantages to encourage him to do so. The Brazil-

87. De Carvalho et al., *supra* note 3, at 7.

88. *Second Brazilian Census*, *supra* note 30, at 70.

89. *Id.*

90. *Id.*

91. De Carvalho, *supra* note 3 at 7.

ian real estate market is growing dramatically, so this type of fund has become more popular in recent years.

Infrastructure Investment Funds (Infrastructure FIPs) were established by Law No. 11,478/07. In passing that law, the Brazilian Government's main goal was to encourage investments in infrastructure.⁹² Specifically, as part of their economic acceleration plan, the government sought to encourage investment in energy, transportation, water, sanitation and irrigation projects.⁹³ Consequently, 95 percent of an Infrastructure FIP's funds must be invested in infrastructure projects.⁹⁴ Infrastructure FIPs require the FIP to organize as a corporation (*sociedade por ações* or *sociedade anônima*, or "'S.A.'"). These are governed by Law No. 6.404/76, "the Corporation's Law," which was revised by Law No. 9.457/97. Regulations require that Infrastructure FIPs comprise at least 10 different quota holders and that each of these holders hold no more than 20 percent of the issued quotas or get more than 20 percent of the fund's total income.⁹⁵ An investor might choose to set up an infrastructure investment fund because he wishes to make a long-term investment with relatively stable returns. The need for infrastructure projects in Brazil is immense, and an investor who has taken more risky positions in other more volatile markets may attempt to balance his portfolio by investing in infrastructure, which is viewed as more stable.

The government has shown its support for infrastructure projects by reducing the tax on financial operations, or IOF for private equity vehicles. On December 15, 2010, the Treasury announced that it was reducing the IOF tax from 6% to 2% to stimulate private sector funding for long-term projects and discussed a growing need for infrastructure improvements.⁹⁶ As discussed in the section on FIPs earlier, the tax has further been reduced to zero.

The availability of industry-specific types of investment vehicles that are specifically encouraged by the Brazilian Government appears to be a good thing insofar as it allows the Brazilian Government to identify areas of strategic growth of the country and to encourage private investment in those areas. It seems that the possibility of arbitrage is low because it is probably easy to tell whether something is an infrastructure investment or a real estate investment, but it may be difficult to determine what constitutes an "emerging company." Further, it could be that companies that specialize in one particular area, for example "Oil and Gas," may simply create a *subsidiary* specialized in a different area, for example "infrastructure," simply in order to receive funds for one particular type of project. If

92. *Second Brazilian Census*, *supra* note 30, at 88-89.

93. *Id.* at 88.

94. *Id.* at 89.

95. *Id.*

96. Juliana Rocha, et. al., *Governo retoma IOF de 2% sobre algumas operações*, FOLHA DE S. PAULO, Dec. 15, 2010, available at <http://www1.folha.uol.com.br/mercado/846392-governo-retoma-iof-de-2-sobre-algumas-operacoes.shtml>.

this sort of investment is allowed, it will be important to keep the funds given to the subsidiary through the infrastructure private equity fund separate from any concurrent projects undertaken by the parent company. This separation of funds may require additional regulatory oversight.

B. *Stage Two: Issues for Investing in the Targeted Company*

Once a private equity investor has chosen which institutional form to use to set up the private equity vehicle, the investor will begin investing in the targeted company. The investor's general goal at this point is to gain control of the company in a way that will allow the investor to make decisions that increase its value, so that the investor can eventually sell it for a profit.

A threshold question is whether Brazil has the appropriate legal protections for shareholders in place that will encourage private equity fund investors to actually make investments in portfolio companies. Basic principles of corporate governance require that a corporation must maximize the objectives of its shareholders. Usually, basic rights that shareholders insist upon include access to relevant, timely information, the ability to participate in and vote at shareholder's meetings, and the ability to elect members of the portfolio company's board of advisors.⁹⁷

To encourage investment, countries must protect both majority and minority shareholders. In countries like Brazil, where older companies are frequently controlled by a few influential shareholders (typically members of a family), protections for minority shareholders has become increasingly important.⁹⁸ In these countries, majority shareholders will seek to maximize their own interests, possibly at the expense of minority shareholders. Simultaneously, minority shareholders suffer from a "free-rider problem," which undermines their incentives to effectively monitor majority shareholders.⁹⁹

Brazil has significantly improved its protections of shareholders in recent years in ways that encourage private equity investment. In 1997, rights for minority shareholders were particularly weak in Brazil. At that time, there were no tag-along rights for minority shareholders, and no

97. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD PRINCIPLES OF CORPORATE GOVERNANCE 33 (2004), available at <http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/31557724.pdf>.

98. See generally Sang-Woo Nam & Il Chong Nam, Corporate Governance in Asia ch. 5 (2004) available at <http://www.adbi.org/files/2005.01.book.corporate.governance.asia.pdf> (discussing the need to for protections for minority shareholders in Asia) and S. Wade Angus and Mariana Pargendler, *Private Equity in Brazil: Opportunities and Challenges for Foreign Investors*, WEIL, GOTSHAL & MANGES at 77 (March 2007 Private Equity Alert), <http://www.weil.com/news/pubdetail.aspx?pub=8017> (discussing the importance of minority protections in Brazil and noting that many Brazilian companies are still managed by family members who are related to the initial founders of the business).

99. See generally NAM & NAM, *supra* note 98.

withdrawal rights in mergers and spin-offs.¹⁰⁰ These laws led to low levels of minority investor confidence and encouraged investment based solely on majority, controlling positions.¹⁰¹ Then, in 2001, the Brazilian Congress reduced the limit of nonvoting stocks from two thirds to 50 percent of total capital stock. Additionally, Congress reinstated tag-along rights for holders of voting shares who paid up to 80 percent of the price paid for the controlling stock, and provided additional advantages for preferred shareholders, including the option to establish certain mandatory minimum dividends for preferred stocks, pricing those dividends higher than voting stocks, and allowing preferred shareholders to have additional tag-along rights upon the sale of the controlling interest.¹⁰² These reforms are generally believed to increase minority shareholder investor protection in Brazil.¹⁰³

1. Permissible Types of Investments and Portfolio Limitations

When choosing a target company (hereinafter “portfolio companies”) to invest in, there are some limitations on what types of investment a private equity vehicle organized as a FIP may make. FIPs may make investments in publicly or privately held corporations in exchange for equity, debt, or instruments exchangeable or convertible into equity.¹⁰⁴ FIPs may not invest directly into other types of companies like limited liability companies, real estate property, or investments outside of Brazil.¹⁰⁵ In 2011, the CVM introduced additional portfolio-shaping guidelines in Instruction 496/11. That instruction requires that at least 90 percent of a private equity fund’s equity come from stocks, bonds, and securities in a *privately held company*.¹⁰⁶ The 2011 new portfolio-shaping limitations clarify that investors cannot take advantage of the FIP structure’s tax benefits to make investments that would otherwise have been taxed at higher rates. Regulators realized a potential for regulatory arbitrage when Brazilian tax law charged a Financial Operations Tax on foreign investors which *varied significantly* based on which type of investment the investor made.¹⁰⁷ “Equity investments” carried a 2 percent tax and “government bonds” carried a 6 percent tax. Without portfolio-shaping regulations, foreign investors were able to use the unregulated private equity fund structure to buy

100. Bruno Meyerhof Salama, *Legal Protection of Minority Shareholders of Listed Corporations in Brazil: Brief History, Legal Structure, and Empirical Evidence*, 4 J. CIV. L. STUD. 147, 152-53 (2011).

101. *Id.* at 153.

102. *Id.* at 154-55.

103. *Id.*

104. *Id.*

105. Baker & McKenzie et al., *supra* note 85.

106. *Id.*

107. Marcelo Loureiro, *CVM Redefines Private Equity Fund Portfolios*, 1 CAPITAL ABERTO INTERNATIONAL EDITION no. 3 (July-Sep. 2011), http://www.capitalaberto.com/eng/lish/ler_artigo.php?pag=7&sec=111&i=3410.

Brazilian Government bonds and call them equity investments, enjoying a significant tax advantage. Instruction 496/11 resolves this arbitrage problem by introducing portfolio-shaping guidelines.¹⁰⁸ This measure seems prudent and is commendable.

2. Choosing a Portfolio Company

Many factors contribute to a private equity fund's decision to invest in a particular portfolio company, including the investor's desired returns, appetite for risk, and the results of due diligence. One crucial difference between the U.S. private equity model and the Brazilian private equity model is the way investment decisions are made. In the United States, investors typically take a "hands off" approach and allow the general partners of the fund to make investment decisions. Comparatively, Brazil's investment decision-making process is notable for the widespread use of "investment committees." Under this model, investment decisions are shared by fund managers and investors. According to the Getulio Vargas Foundation, among those funds that use investment committees, 43 percent require approval from a simple majority before making investment decisions, 32 percent require a qualified majority, and 25 percent require unanimity.¹⁰⁹

Fabio Massao Inocima praises the use of "investment committees" as a corporate governance model commonly used in Brazilian private equity investment vehicles. Massao Inocima points out that because the fund manager usually has only one or two seats on the investment committee, which is typically comprised of four to eight members, the requirements for majorities, qualified majorities, and unanimity (as the case may be) reduces information asymmetries between principals (investor) and agents (fund managers).¹¹⁰ Accordingly, this reduces agency costs and improves investor protection.¹¹¹ At least in theory, this may also produce better quality investments, since investors will conduct a more stringent screening at the beginning of the investment cycle, possibly lowering the chances that the fund manager will pay too much for a company or make a poor investment decision.¹¹²

On the other hand, some US investors find the involvement of investment committees burdensome. For these investors, the consensus building process undermines efficiency and gives investors too much say in leader-

108. *CVM edita Instrução que altera regras sobre composição da carteira dos FIP*, available at <http://www.cvm.gov.br/port/infos/Comunicado-496.asp>.

109. OVERVIEW, *supra* note 32.

110. Fabio Massao Inocima, *Governance, Leverage, and Cyclicalities: The Efficiency of the Brazilian Private Equity Model* 26 (2010) (unpublished manuscript) (on file with author).

111. *Id.*

112. *Id.*

ship decisions, particularly when the investors involve large Brazilian pension funds, which are increasingly vocal in management decisions.¹¹³

3. Gaining Control of the Portfolio Company

FIPs must exert real influence on the strategic policies of the companies that they invest in and participate in their management.¹¹⁴ There are two ways that a FIP can fulfill the “real influence” requirement: (1) they can purchase a minority equity interest in a company and execute a shareholders (or “quota-holders” agreement) to grant them effective control; or, (2) they can buy a majority interest in a portfolio company and obtain statutorily-defined levels of control.¹¹⁵ Each of these ways of gaining control, and their benefits and downsides, are discussed in this section.

Before embarking on a discussion of how to make majority or minority investments in target portfolio companies, it would be useful to know exactly how many firms actually take on minority positions versus majority positions and which techniques are used to gain control of most companies. However, since companies are not required to disclose this information for private acquisitions at present, information regarding actual investment behavior is mostly anecdotal.

According to a 2007 private equity report by Weil, Gotshal & Manges, LLP, the strategy most commonly used by most private equity sponsors in Brazil at that time was to acquire a controlling position in local companies, either by purchasing common stock or other equity interests.¹¹⁶ However, since the financial crisis there appears to be a clear trend towards taking minority positions in Brazil.¹¹⁷ For example, Gávea Investimentos, a Brazilian private equity firm, bases its entire strategy on acquiring minority positions in firms.¹¹⁸ Gávea acquires 10 to 25 percent minority stakes in companies because it believes the premium for control is too high in Brazil.¹¹⁹ This strategy led Gávea to be a local industry leader and to its recent acquisition by JPMorgan.¹²⁰

113. *Battle for Private Equity Autonomy*, BRAZIL CONFIDENTIAL (Jan. 6, 2012), <http://www.brazilconfidential.com/Finance/FundFlows/Features/Finance/article/20120106/82462d74-2736-11e1-a82d-00144f2af8e8/Battle-for-private-equity-autonomy>.

114. CMV Instruction No. 391/03, available at http://www.cvm.gov.br/ingl/regu/cvm_391.ASP.

115. Baker & McKenzie, *supra* note 85.

116. Angus & Pargendler, *supra* note 98.

117. Daniel de Souza et al., *Private Equity in Brazil: Entering a New Era*, KNOWLEDGE@WHARTON (Jan. 26, 2011), <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2685>. See also Baker & McKenzie, *supra* note 85, at 5; *The Buys from Brazil: This Year's Hot Market for Private-Equity Firms and Hedge-Fund Managers*, THE ECONOMIST, Feb. 17, 2011, at 6 [hereinafter *The Buys*].

118. de Souza, *supra* note 117.

119. Mitchell, *supra* note 1, at 4.

120. *Id.*

“Club deals”—in which three or more managers of different private equity funds unite to capitalize a portfolio company and compete with larger private equity firms—are popular in more developed private equity markets but are not yet common in Brazil. Some believe this type of investment strategy is just around the corner in Brazil due to the increased number of private equity firms sprouting up in the country and the competition among them.¹²¹ If club deals do emerge, these would allow private equity fund managers to seek out partnerships with other managers when they identify an investment they would like to make, but cannot afford alone. If the private equity fund manager sees a significant upside to the investment and trusts the other private equity funds involved, he would be able to realize profits on deals that would otherwise be inaccessible.¹²² Portfolio companies could benefit by having increased access to capital and gain additional perspectives and guidance in their investment decisions, possibly improving their operations.¹²³ For now, simply buying a minority or majority equity stake in a portfolio company remains the norm.

a. Buying Minority Equity Interests and Using Shareholder’s Agreements

One common way to gain control over a portfolio company is to buy a minority stake in the company and then execute a shareholder’s (or “quota holder’s”) agreement with the controlling shareholders to grant the private equity company certain powers. If the company is publicly traded, private equity funds can gain control over it by buying a minority stake and executing a shareholders’ agreement between the fund and the other equity holders of the portfolio company. If the company is privately held, it will also issue shares or quotas (depending on their organizational form) to their investors. Just as with publicly-traded companies, shareholder’s or quota holder’s allow a private equity fund to buy a minority equity stake in a privately traded company and contract with the current owners in a way that grants the private equity fund the power to make the important managerial decisions and exercise real influence over the company without gaining a majority position.

According to Baker & McKenzie, Brazilian shareholder’s agreements usually provide the private equity firm with certain veto powers over major decisions to be made in the firm, the ability to appoint members of the board of advisors, the ability to have a say whenever there will be a transfer of equity ownership (e.g., rights of first refusal, first offer, tag-along, and drag-along rights), and rights related to exit opportunities and obligations, such as put option rights, redemption rights, and a clause acknowl-

121. Marila Avila, *Buyers’ Club: Mega-Operations and Fiercer Competition Among Private Equity Managers Indicate that “Club Deals” Will Soon Reach Brazil*, CAPITAL ABERTO BRAZILIAN EDITION (Oct. 2010), http://www.capitalaberto.com.br/english/ler_artigo.php?pag=2&i=3069&sec=89.

122. *Id.*

123. *Id.*

edging that the parties intend to exit as soon as possible.¹²⁴ The shareholder's agreement also specifies that the portfolio company must give the investors or board of directors regular updates and provide them with information in a timely manner, reserving the right for investors to appoint independent accountants if they see fit. If the private equity firm believes that it may exit through an IPO on the U.S. market, the shareholder's agreement will contain some registration rights, which allow investors to demand that the company register with the SEC, or "piggy back" registration rights, which allow the investors the option of having their shares registered at the same time that other shares in the company are registered.¹²⁵

Generally, the usefulness of a shareholder's agreement is that it allows companies to negotiate control without expending significant amounts of money to actually purchase shares in the company. This can benefit the existing shareholders, because they are able to retain their equity interests in the company and (while giving up some amount of control) may benefit from the advice and expertise of the private equity firm, which makes their shares more valuable.

b. *Buying Majority Equity Interests in Portfolio Companies*

Without a shareholder or quota-holders agreement, a private equity fund may purchase shares or quotas from the investors that own them to gain control. If the privately-held portfolio company is organized as a limited liability company, it issues "quotas" to raise its funds. Where there is no quota-holders agreement in place, "control" of a limited liability company is defined as holding at least 75 percent of its capital.¹²⁶ If the privately-held portfolio company is organized as a closed-end corporation (*Sociedade Anônima de Capital Fechado*), the private equity vehicle will purchase the company's "shares."¹²⁷ In this case, control without a shareholder's agreement is defined as having rights that permanently assure the party of a simple majority (50%) in votes of general meetings, the power to elect a majority of the corporation's officers, and actually using this power to direct the corporate activities.¹²⁸ The techniques and procedures for obtaining these levels of control vary based on whether the target portfolio company is publicly or privately held.

124. Baker & McKenzie, *supra* note 85, at 8.

125. *Id.*

126. Tozzini, Freire, *Foreign Investment in Brazil*, TEIXEIRA E SILVA ADVOGADOS (March 2004), http://www.prac.org/newsletters/Foreign_Investment_In_Brazil.pdf

127. Lei Das Sociedades Anônimas [Article 1 of Law No. 6,404 of December 15, 1976, Brazilian Corporations Law], available at <http://www.cvm.gov.br/ingl/regu/law6404r.ASP>.

128. Lei Das Sociedades Anônimas [Article 116 of Law No. 6,404 of December 15, 1976, Brazilian Corporations Law], available at <http://www.cvm.gov.br/ingl/regu/law6404r.ASP>.

i. Majority Interests in Publicly-Traded Companies

When the target company is a publicly traded company, the CVM will regulate the purchase of its shares. FIPs may purchase stock, debentures, subscription bonuses, and other securities, which can be converted into stock when these are issued by publicly-held or closely-held companies; but only previously specified publicly-held companies may receive investments from FIPs.¹²⁹ The FIP's Regulation (the document that the organizer provides at the funds registration) specifies which publicly-held companies can receive a FIP's investments. Accordingly, a FIP cannot just invest in publicly-held companies haphazardly; such investment must be part of its strategic plan from the time of set-up. If a FIP wishes to simply buy up shares on the open market using accumulated funds, the process for purchasing shares will be overseen by the CVM.

The mechanism requiring FIPs to specify which types of publicly traded companies will receive an investment appears to be a good thing insofar as it gives the CVM notice about which FIPs will have a role investing in the Brazilian stock markets, the CVM's primary area of concern. It also encourages sound planning at the setup stage to develop an investment strategy before raising funds, which contributes to investor protection. Notably, qualified investors would most likely insist on this type of foresight and planning even without this regulation, so it likely does not impose additional costs on the FIP and, on balance, probably only helps the CVM carry out its mission.

The most common strategy employed by private equity firms in Brazil to invest in a public target company is to use the money that the FIP has raised to acquire a controlling position in a company by purchasing common stock or other voting equity interests.¹³⁰ If the FIP does not have a large amount of money available to buy enough equity to gain control of the company, it may use debt to purchase the necessary shares. In a leveraged buyout ("LBO") situation, the investor uses debt instruments from bank and capital markets to purchase a controlling interest in a company. The assets of the company being "bought out" are used as collateral in this transaction.

Leveraged buyouts are very uncommon in Brazil because Brazil has not developed a strong local debt financing market.¹³¹ Most deals are financed entirely with equity, and when debt is taken out, the deals tend to have low debt-to-equity ratios.¹³² In general, Brazilian private equity deals are financed, on average, with zero percent debt; furthermore, when leverage is used, it is limited to two and a half times EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization, a metric used to attempt to measure cash earnings).¹³³ By contrast, U.S. and European

129. Flesch & Silva Prado, *supra* note 44, at 81.

130. Angus & Pargendler, *supra* note 98, at 77.

131. *Id.* at 69.

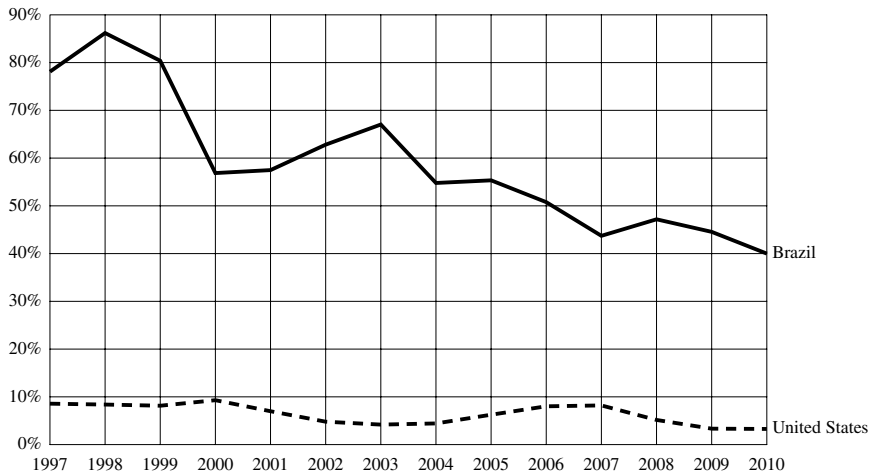
132. *See* de Souza, *supra* note 117.

133. *Id.*

LBO markets have used leverage as much as four to seven times EBITDA.¹³⁴

LBOs are uncommon in Brazil because debt is extremely expensive, as compared to other countries. In February 2011, the average rate for a commercial business loan was 29 percent.¹³⁵ Historically, the *Banco Nacional de Desenvolvimento* (BNDES) was the only source of debt financing available to private equity sponsors, meaning that there was little competition for debt financing and that firms suffered higher prices.¹³⁶ Furthermore, interest rates in Brazil have historically been quite high as compared to other places in the world, increasing the cost of debt financing. The graph below in Table 4 demonstrates the cost of debt in Brazil, as measured by the lending interest rate, compared to the cost of debt in the United States, between 1997 and 2010 (created using data from the World Bank¹³⁷ in combination with Google's Public Data Feature).¹³⁸

TABLE 4: COST OF DEBT IN BRAZIL COMPARED TO COST OF DEBT IN U.S.



There is a significant amount of literature that suggests that Brazil's lack of leverage is actually a good thing for the Brazilian private equity industry. Fabio Massao Inocima argues that the lack of leverage in acquisitions in Brazil allows for better protection of limited partners' interests and a more efficient investment model that enjoys a countercyclical na-

134. *Id.*

135. *The Buys*, *supra* note 117.

136. *Id.*

137. *Brazil*, THE WORLD BANK, <http://data.worldbank.org/country/brazil> (last visited Nov. 27, 2012).

138. *Public Data*, GOOGLE, <http://www.google.com/publicdata/directory> (last visited Nov. 27, 2012).

ture.¹³⁹ As long as the members of the investment committee are as financially savvy as the general partner, the investment committee does not stall decision-making to the extent that it results in a competitive disadvantage for the general partner, and conflicts of interest are avoided.¹⁴⁰

Many Brazilian private equity firms similarly believe that the lack of leverage in the Brazilian private equity markets is an asset. According to Caludo Furtado, the executive director of the Center for Private Equity and Venture Capital Research at the Fundacao Getulio Vargas, Brazil's lack of leverage means that the private equity industry in Brazil presents less risk.¹⁴¹ For investments to succeed in Brazil, he argues, private equity players cannot rely on "financial engineering" but instead must focus on core strategic and operational improvements, leading to better results.¹⁴² Patrice Etline, a managing partner for Latin America at a large private equity fund, described a successful deal as follows: "We created value not through changing the capital structure or taking on cheap acquisition debt."¹⁴³ Many Brazilian private equity firms worry that increased leverage, even if it means more readily available credit, will be damaging to Brazil's private equity market overall.¹⁴⁴ Brazilian managers are acutely aware of the number of highly-leveraged deals that have failed in the West, and tend to view Brazil's lack of leverage as one of the industry's core assets.¹⁴⁵ Alvaro Gonçalves of Stratus, a Brazilian private equity firm, states, "I hope we can avoid the image that we are raiders and vultures, this is the profile that these large LBO firms left in markets, and we don't want them to do that here."¹⁴⁶

High levels of leverage may likely increase systemic risks posed by private equity investment activity. Viral V. Acharya, et al. argue that regulators should better scrutinize the risks inherent in the pre-crisis boom in LBO financing in the U.S. and Europe.¹⁴⁷ The authors suggest that many of the practices that generated systemic risk in the subprime mortgage industry also exist for LBOs. In LBO lending scenarios in the U.S., loans frequently do not remain on the books of the banks that originate them; so the originators have less incentive to effectively screen and monitor candidates' ability to pay them back.¹⁴⁸ Further, since LBO loans are often collateralized, ultimate debt ownership of LBO loans can be opaque; meaning that a few large defaults might cause funding to dry up for finan-

139. Inocima, *supra* note 110, at 41.

140. *Id.*

141. Mitchell, *supra* note 1.

142. *Id.*

143. *Id.*

144. *The Buys, supra* note 117.

145. *Id.*

146. *Id.*

147. See Viral V. Acharya, et al., *Private Equity: Boom and Bust?*, 19 J. OF APPLIED CORP. FIN. 3 (2007).

148. *Id.* at 4.

cial institutions.¹⁴⁹ Policy-makers should examine, whether incentives are properly aligned in the debt-origination processes, and attempt to improve transparency related to debt ownership when LBO loans are collateralized.¹⁵⁰ According to the authors, if even a few large LBO deals default, causing a small shock to the LBO markets, there may be repercussions similar to those of the subprime market (particularly the drying up of liquidity).¹⁵¹

However, there are many reasons that Brazil might benefit by lowering the cost of debt, a policy that would likely encourage leveraged buyouts. Even though Brazil has successfully developed a private equity industry in which deals are not highly leveraged and the country has arguably enjoyed the collateral policy benefit of a decrease in systemic risk, the lack of leverage is merely a byproduct of the country's extremely high cost of debt, and not the result of direct regulatory policy choices. Making debt less expensive might contribute to dynamism in the real economy by encouraging investment, and allowing those who are potentially well-qualified to manage large, expensive companies, to do so through leverage. According to Prahel et al., in their 2001 Survey of Limited Partners, debt availability was ranked first in the perception of limited partners and second by general partners among the main issues for investors in Brazil.¹⁵² The unavailability of debt on reasonable conditions particularly harms small and medium-sized enterprises, who struggle to access debt amid double-digit interest rates and high risk premiums.¹⁵³ According to the survey, this means that returns are limited from both debt pay-down and foregone growth projects.¹⁵⁴

ii. Majority Interests in Privately-Held Companies

If a target portfolio company that is privately-held, and the private equity vehicle is organized as a FIP, the portfolio company must first meet certain corporate governance standards. First, the target portfolio company may not issue special shares for founders (*partes beneficiarias*) or redeem those in circulation.¹⁵⁵ This prevents against the creation of unequal classes of shareholders in which the private equity vehicle's investment would be diluted. Second, all of the members on the board of directors must have a unified term of one year (no staggering of board positions).¹⁵⁶ This allows the private equity vehicle to know with certainty the composition of the board and prevents the portfolio company from retaining de facto control by leaving its own members of the board on for

149. *Id.*

150. *Id.*

151. *Id.* at 9.

152. Prahel et al., *supra* note 13.

153. *Id.*

154. *Id.*

155. Flesch & Silva Prado, *supra* note 44, at 83.

156. *Id.*

very long periods of time. This concern is ameliorated because, in the case of acquisition, the FIP will be required to appoint members of the portfolio company's board, as previously discussed. Next, any related-party agreements, shareholder's agreements, and stock options programs must be disclosed.¹⁵⁷ This allows the private equity vehicle to accurately judge the assets, liabilities, and stake holders associated with the portfolio company. The portfolio company must also adopt arbitration procedures to resolve any future disputes.¹⁵⁸ Mandatory arbitration helps avoid the slow, and sometimes unpredictable, Brazilian court systems. In the case of an eventual IPO, the company must agree to list on the *Novo Mercado* segment of the Brazilian Stock Market, BOVESPA, which imposes stricter corporate governance standards than other trading segments.¹⁵⁹ Finally, the company must use an independent auditor, registered with the CVM, to conduct an annual audit of its financial statements.¹⁶⁰ This encourages quality of reporting of information, so the private equity vehicle and the Brazilian capital markets (in the case of an IPO) are able to accurately value the portfolio company.

The Brazilian Government's decision to impose stricter corporate governance standards on privately-held companies which receive investments from FIPs raises various regulatory choice issues. While the requirement to use stringent corporate governance standards seems like a good thing, it might lead to economic inefficiencies if the costs of compliance outweigh the benefits. There may be reason to believe that some growing companies should not be held the strictest of corporate governance standards because smaller, growing companies pose fewer risks to the system and have less money to spend on adhering to burdensome regulations.

On the other hand, if corporate governance does have important tangible benefits that the regulators feel are important, why draw the line between public companies and private companies? Why not impose a blanket rule that *any* company, that wishes to receive investment from FIPs or other private equity vehicles, must abide by those corporate governance standards? Perhaps the rationale is that when a company requires an infusion of capital it may be in bad shape and already practice poor corporate governance. Requiring these companies to improve their corporate governance ensures that a PE investment will be more effective.

On balance, the imposition of corporate governance standards on privately-held portfolio companies is likely a sound policy choice. These restrictions, while they may impose some costs on companies that wish to receive investments, appear to advance the goals of investor protection for all investors, not just qualified investors. Furthermore, requiring firms that wish to receive private equity investments to meet corporate govern-

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.* at 84.

ance standards may serve as a good filter for determining which firms will be good investments in the long-run. By this logic, if a firm cannot meet standards that are generally agreed to be “good” for business, then the firm it probably not a good investment anyway. Even though the restrictions on investments in privately-held portfolio companies can be seen as paternalistic, they may also encourage a more robust, competitive environment.

C. Stage Three: Management of the Portfolio Company

Once a private equity fund has made an investment in a target company and acquired decision-making power through a share-holder’s agreement or control of the target company, it will begin to attempt to make that company more valuable so that it can eventually sell it. The fund may engage in various management techniques to increase the company’s value, including: rebranding the company, changing up the management structure (e.g., layoffs, strategic hiring, providing better incentives for current employees), eliminating unproductive products, investments, or activities, or adding new products. Generally, the level of prudential oversight during this period is very low, and because the fund is privately held it is generally left to its own business judgment to make prudent decisions regarding the management of its portfolio companies. The main regulations that apply during this period involve general disclosure and data-reporting to the CVM and increasingly to ANBIMA (as a self-regulating agency among members).

A FIP is required to periodically disclose information about its financial position, including providing an audited financial statement from an independent auditor registered with the CVM each year.¹⁶¹ Specifically, the FIP must prepare annual and semi-annual financial statements, provide an opinion regarding its operations and results, disclose its net worth and the number of quotas issued each quarter, disclose its portfolio and the net worth of the quotas and their profitability, and any other material facts related to the FIP.¹⁶²

For funds opened in March 2011 or later that are also members of ANBIMA or the Brazilian Association of Private Equity and Venture Capital (ABVCAP), adherence to self-regulatory code will require that the funds turn over additional data related to their management activities.¹⁶³ In June of 2011, the ABVCAP announced plans to set up a database of private equity and venture capital funds to comply with the code and provide consolidated, aggregate data regarding the industry. The data may show the total number and quantity of investments made in

161. Flesch & Silva Prado, *supra* note 44, at 88.

162. Baker & McKenzie, *supra* note 85, at 3.

163. Marcelo Loureiro, *Private Equity in Numbers: ABVCap Releases Tool to Provide PE Fund Managers With Information About Their Industry*, 8 CAP. ABERTO BRAZILIAN EDITION, no. 94, June 2011, [http://www.capitalaberto.com/english/ler_artigo.php?pag=2&sec=77&i=3424&btxt=private%20equity.\(last visited Mar. 11, 2012\)](http://www.capitalaberto.com/english/ler_artigo.php?pag=2&sec=77&i=3424&btxt=private%20equity.(last visited Mar. 11, 2012)).

a given industry or the number of private equity and venture capital entities raising funds over time, but will maintain the confidentiality of individual funds and not link any one fund to particular activities.¹⁶⁴ On March 23, 2012, ANBIMA's Council for the Regulation and Best Practices of Private Equity and Venture Capital Funds distributed instructions that entered into effect on March 26, 2012.¹⁶⁵ These instructions establish information-sharing practices that private equity funds should follow when certain events occur, such as investment or withdrawal from a company. According to the document, after a private equity fund makes an important decision, it should send information about the investment within 20 days to the ABVCAP database.¹⁶⁶ This rule, by its terms, is binding on all members of ANBIMA, subject to ANBIMA's oversight and enforcement, the value of which is questioned in other parts of this note.¹⁶⁷

In general, the lack of oversight (except data-reporting) during the management stage appears to make sense. Since the companies in question are privately-held, they do not pose a threat to any shareholders other than those qualified investors that specifically chose to put their money in them. Basic principles of investor protection suggest that these investors are able to protect themselves.

D. Stage Four: Exiting the Private Equity Investment

The investor's ultimate goal in any private equity investment is to realize a profit by divesting himself of his investment and selling it for more money than he initially paid for his stake in the investment. Usually, private equity investors seek to exit their investment within seven to ten years. There are several strategies used to exit an investment. An investor can: (1) sell his investment to the public at large by conducting an IPO; (2) sell his investment to another qualified investor in a private sale; (3) redeem his shares; or, (4) merge the company with another company. This section discusses only those regulations that govern IPOs and the possible benefits and downsides of the current regulatory framework.¹⁶⁸

As a threshold question, it is important to determine whether Brazil has in place the right environment to allow for successful IPOs on the São Paulo Stock Exchange. The ability to conduct an IPO is crucial for healthy equity markets (and the private equity industry) because it allows

164. *Id.*

165. *See Code for the Regulation and Best Practices, supra* note 28.

166. *Id.*

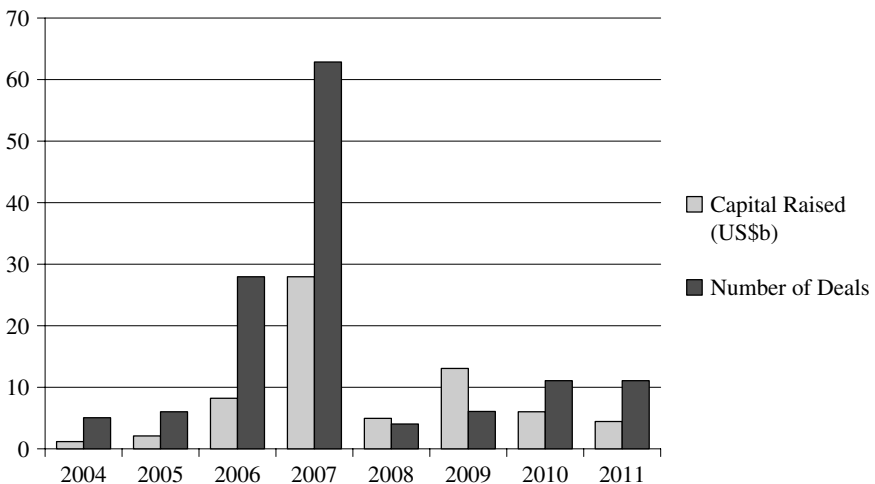
167. *Id.*

168. The sale of investments to other qualified investors is governed by the same principles discussed in earlier parts of this note. Redemption of shares in a private equity vehicle is governed by the contract set out between an investor and the private equity fund in the initial investment agreement. For reasons beyond the scope of this note the Brazilian bureaucratic system makes mergers extremely uncommon in Brazil. Rather than go through the process of combining two legal identities (it can take years to work its way through Brazil's administrative system) companies usually prefer to simply create a new entity.

investors to see a clear exit as a viable opportunity. As discussed below, Brazil has laid the regulatory and economic groundwork to allow for a flourishing IPO market, but that market has slowed down, which is in line with trend of decreasing IPOs worldwide after the financial crisis.

In the years before the financial crisis, the development of stable and diversified capital markets in Brazil increased liquidity for private equity investors and made IPOs an attractive exit alternative.¹⁶⁹ In general, the number of IPOs increased significantly in the years leading up to the crisis. Numbers peaked in 2007, and decreased in the following years. In early 2008, before the financial crisis, the MSCI Global Emerging Market Index (which measures equity market performance in emerging markets) ranked Brazil number one.¹⁷⁰ Before 2008, Brazil's IPO market was booming. The following graph in Table 5 (based upon Ernst & Young data) illustrates the number of IPOs in Brazil in recent years.¹⁷¹

TABLE 5: NUMBER OF IPOs IN BRAZIL AND CAPITAL RAISED



As of November 23, 2012, only 4 IPOs had been conducted, in spite of early media murmurs that 2012 would be a good year for IPOs.¹⁷² While three IPOs were planned for the beginning of 2012, each fell through.¹⁷³

169. Angus & Pargendler, *supra* note 98, at 65.

170. *Id.* at 66.

171. Data compiled from Ernst & Young, *Global IPO Trends 2011*, ERNST & YOUNG 18 (2011), http://drivkraft.ey.se/wp-content/blogs.dir/5/files/2011/06/Global_IPO_trends-report_2011.pdf and Ernst & Young, *Global IP Trends 2012*, ERNST & YOUNG 19 (2012), [http://www.ey.com/Publication/vwLUAssets/Global_IPO_trends_2012/\\$FILE/Global_IPO_trends_2012.pdf](http://www.ey.com/Publication/vwLUAssets/Global_IPO_trends_2012/$FILE/Global_IPO_trends_2012.pdf)

172. *M&A, Debt Issuance Made Up for Weak Brazil IPO Market in 2012*, CREDIT SUISSE (Nov. 23, 2012), <http://www.4-traders.com/news/M-A-Debt-Issuance-Made-Up-for-Weak-Brazil-IPO-Market-in-2012-Credit-Suisse—15540112/>.

173. *Locamerica Cuts Price of Brazil's First 2012 IPO*, REUTERS (Apr. 19, 2012), <http://www.reuters.com/article/2012/04/19/locamerica-idUSL2E8FJELT20120419>.

The first IPO of the year, Locamerca, was listed only in Spring of 2012 at 18 percent below its suggested price. Shares for Locamerca started trading on April 23, 2012.¹⁷⁴ Despite early reports that suggested that the market would pick back up in early 2012, during the first few months of the year commentators began to realize that 2012 would not be a year of spectacular recovery.¹⁷⁵ The problem of IPO pricing, and setting realistic list-prices, may explain current market conditions. According to Rob Dwyer from EuroMoney Magazine, some bankers claim that Brazil's IPO market is suffering an "identity crisis." This is due to the fact that even though Brazil has reached investment-grade status and relative economic maturity, companies keep trying to price their shares at multiples comparable to other emerging markets, and the discrepancy is not sustainable.¹⁷⁶

Even though Brazil has seen a slow-down in its IPO activity since the worldwide financial crisis, it is easy to conclude that Brazil has laid the groundwork in terms of regulations to allow for a flourishing IPO market. The following discusses the key regulatory improvement that has made IPOs an attractive exit opportunity in the past, and hopefully in the future.

BOVESPA's decision in 2000 to launch a special new listing scheme, which allowed companies to list with three different levels of corporate governance standards, has been widely hailed as the key regulatory development that encouraged IPO activity in the years leading up to the crisis. Under the *Novo Mercado* model, companies are allowed to list on the BOVESPA stock exchange in three different trading segments: Level 1, Level 2, or *Novo Mercado*.

The *Novo Mercado* model allows companies to voluntarily choose which trading segment to list under. Different segments require increasingly more strict corporate governance standards than the baseline requirements under the Brazilian Corporations Law. To list on the segment with the highest standards, the *Novo Mercado*, companies must issue only a single class of stock (with no non-voting preferred stock) and have a minimum of 25 percent of the corporation's issued stock in circulation.¹⁷⁷ Minority shareholders are granted tag-along rights that allow them to receive the same premium paid to controlling shareholders if there is a change in control over the company. The company must have a unified term for all board members, and a minimum of 20 percent of the directors on the company's board must be "independent." In the case of corporate

174. *Id.*

175. Rogério Jelmayer, *Ernst & Young Terco Sees 20 IPOs Likely For Brazil in 2012*, 4-TRADERS (Feb. 16, 2012, 11:37 AM), <http://www.4-traders.com/SEADRILL-LIMITED-6134373/news/Ernst-Young-Terco-Sees-20-IPOs-Likely-For-Brazil-In-2012-14027566/>.

176. Rob Dwyer, *Brazil's Equities Market Suffers an Identity Crisis*, EUROMONEY (Jan. 2012), <http://www.euromoney.com/Article/2962118/Brazils-equities-market-suffers-an-identity-crisis.html>.

177. *Id.* at 67; See generally Ronald J. Gilson et al., *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 63 STAN. L. REV. 475 (2010).

disputes, companies must also agree to mandatory arbitration, which reduces the uncertainty of dealing with the Brazilian judicial system. If the company opts out of the *Novo Mercado* segment or delists, there is a mandatory bid for all shares in circulation. This ostensibly prevents arbitrage that would allow a company to list on the *Novo Mercado* for the sake of the trading premium associated with stronger corporate governance, only to delist after realizing the value.

Brazil's *Novo Mercado* model has been generally heralded as a positive regulatory development that has effectively helped to improve corporate governance.¹⁷⁸ Data suggests that the *Novo Mercado* model has also been extremely popular. Of the 64 companies listing on BOVESPA in 2007, over two thirds chose to list their shares on the *Novo Mercado*.¹⁷⁹ According to Gilson, Brazil's use of the *Novo Mercado* has allowed the country to overcome what he calls the "Olson Problem" (named after Mancur Olson).¹⁸⁰ This phenomenon explains that in developing countries like Brazil the entrenched economic elite wield significant political clout and have incentives to combat any government-led efforts towards improvements in corporate governance which might improve the country's macroeconomic climate overall but undermine their tight grip on economic power.¹⁸¹ Gilson argues that Brazil prior to the implementation of the *Novo Mercado* model in 2000 was a paradigmatic example of a country suffering from the Olson problem, where entrenched economic interests had little incentive to impose stricter corporate governance standards, discouraging investment overall but maximizing the elites' own interests.¹⁸² He contends that the *Novo Mercado* is a form of "regulatory dualism" which can combat the Olson problem by allowing elites to remain governed by the previous regulatory regime, while allowing newcomers to choose to adhere to stricter regulations, on a voluntary basis.¹⁸³ This, he argues, can be more politically tenable than massive regulatory overhaul, which will likely face fierce opposition from those content with the status quo.¹⁸⁴

The *Novo Mercado* model may be criticized on the grounds that if corporate governance is truly important goal essential for healthy markets, then it should be a strict requirement imposed on every company seeking to list on a Brazilian stock exchange. As Gilson, points out, however, these kinds of sweeping changes can be cumbersome to enact and often fail, leaving countries with less corporate governance than if they had just let companies pick and choose their level of governance. In the context of private equity, the Brazilian Government has laudably taken a harder

178. Angus & Pargendler, *supra* note 98, at 67.

179. *Id.* at 68.

180. Gilson et al., *supra* note 177, at 494.

181. *Id.*

182. *Id.* at 482.

183. *Id.* at 478.

184. *Id.*

stance on corporate governance, by requiring any privately-held company that receive investments from a FIP to list on the *Novo Mercado*, as in the case of an IPO. For reasons discussed in Section III, this appears to be a very prudent policy. The *Novo Mercado* model strikes a good balance between the goals of encouraging good corporate governance and effectuating reform in a way that combats the Olson problem. By allowing companies to choose to subject themselves to higher standards of corporate governance, it allows those companies to reap the rewards from those investors that are eager to invest in companies, which they believe have better business practices. The model proves to be effective in encouraging activity on the Brazilian stock exchange, while also improving the quality of companies listing, and promoting healthy, flourishing equity markets. However, because the Brazilian stock markets have changed significantly since 2000 (having experienced a string of IPOs in the lead up to the financial crisis and achieved investment grade status in 2008), Brazilian regulators should ask whether or not the *Novo Mercado* listing scheme is still the most effective way of encouraging companies to list on BOVESPA. Considering the stagnation in the number of IPOs since 2008, it may be time to implement more aggressive policies that encourage new listings.

PART IV: CONCLUSION

In Part II of this note, I demonstrated that the Brazilian private equity market has experienced a period of massive growth over the past ten years and appears poised to grow even more in the future. Key to this increased private equity activity was Brazil's ability to promote macroeconomic stability by reigning in inflation, the government's overt encouragement of private equity funds through the creation of the FIP investment form, the reduction in capital gains taxes associated with private equity investments, and the changes in regulatory policies that allowed Brazilian pension funds to invest directly in private equity investment vehicles. I showed that the main regulators of the private equity industry in Brazil are the Brazilian Securities and Exchange Commission (the "CVM") and the self-regulatory ANBIMA Association and BOVESPA São Paulo Stock exchange. In general, I demonstrated that Brazil has taken a relatively "hands off" approach to private equity regulation, as evidenced by the CVM's minimal registration requirements and reluctance to scrutinize private equity activity until that activity touches the capital markets.

In Part III of this note, I analyzed the regulations governing a private equity investment vehicle throughout the lifetime of that investment. I found that the Brazilian Government has successfully encouraged investment in private equity vehicles by allowing vehicles to organize as a limited partnership under the laws of another country (typically under the laws of Delaware in the United States), and by creating a special type of private equity investment vehicle, the FIP, with tax benefits substantially similar to the limited partnership form enjoyed in the United States. I found that while the Brazilian Government has very successfully en-

couraged private equity investment through FIPs and more targeted infrastructure and real estate funds, its investment vehicle dedicated to encouraging venture capital investments, the FMIEE, has been less successful. Given the importance of venture capital to market dynamism and prosperity, I recommended that Brazil reassess the incentives it provides to the FMIEE fund structure. I found that Brazil has effectuated the necessary investor protections to encourage investment in portfolio companies, but that investors have needed to rely on arbitration as opposed to the Brazilian court system to enforce their rights. Accordingly, I recommend that Brazil improve its legal system's efficiency and predictability to encourage more investment. I showed that regulations related to management of the private equity investment are sparse and limited to the requirement to disclose information related to the companies' financial position, which is a good thing insofar as Brazil insists on high standards of accounting. Lastly, I found that Brazil has laid the regulatory groundwork to encourage viable exit opportunities by allowing companies to pick and choose their ideal level of corporate governance using the São Paulo Stock Exchange's *Novo Mercado* model.

In my subsequent note, published in this Journal's next issue, I will critique the regulatory choices Brazil has made in regulating its private equity industry as described in this note, and provide suggestions for further improvement.

