

**BRAZILIAN PRIVATE EQUITY FUNDS (FIPs):
A DNA CHANGE IN BRAZILIAN M&A DEALS**

*José Carlos Junqueira Sampaio Meirelles**
Caio Carlos Cruz Ferreira Silva†

I. M&A ACTIVITY AND THE PRIVATE EQUITY SCENARIO IN BRAZIL

Brazil has become a preferred destination for private equity¹ investments from all over the globe.² The country's recently achieved investment-grade³ status was perhaps the missing push needed to put Brazil on the radar of private equity investors and in the

* Corporate Partner, Pinheiro Neto Advogados; Adjunct Professor of the University of Illinois; Guest Faculty Member of Duke University School of Law; LL.B., University of São Paulo Law School, 1986; LL.M., University of Illinois, 1989.

† Corporate Senior Associate, Pinheiro Neto Advogados; LL.B., University of São Paulo Law School, 2003; LL.M. in International Law, University of São Paulo Law School, 2007; LL.M., Harvard Law School, 2011.

¹ In this Article, references to private equity are used in accordance with the broad definition in article 2 of CVM Rule 391/03, a rule issued by the Brazilian Securities and Exchange Commission (*Comissão de Valores Mobiliários* (CVM)) introducing the Brazilian version of private equity funds. *See infra* Part II. Under this definition, private equity includes any acquisition of, or investment in, securities of a Brazilian publicly or closely held corporation with the purpose of actively participating in its decision-making process and influencing its capital structure, management, and operations through the adoption of value-enhancing strategic policies.

² *See, e.g.*, Guillermo Parra-Bernal, *Big private equity eyes Brazil for tasty deals*, REUTERS (Dec. 16, 2009), available at <http://www.reuters.com/article/2009/12/16/us-brazil-privateequity-analysis-idUSTRE5BF2DL20091216>; Spencer Ante, *Brazil: The next hotbed of venture capital and private equity*, BUSINESSWEEK.COM (Jun. 29, 2009), http://www.businessweek.com/the_thread/techbeat/archives/2009/06/brazil_the_next_hotbed_of_venture_capital_and_private_equity.html; Mike Dorning, *U.S. Loses No. 1 to Brazil-China-India Market in Investor Poll*, BLOOMBERG (Sep. 21, 2010), <http://www.bloomberg.com/news/2010-09-21/u-s-loses-no-1-to-brazil-china-india-market-in-global-poll-on-investing.html>.

³ In general, "investment grade" refers to a classification assigned by rating agencies to entities that are deemed capable of paying off their debt.

mainstream of international business transactions.⁴

The longstanding efforts undertaken in Brazil to reconcile sustainable growth with sound economic policies and reliable legal and regulatory frameworks have helped steer the country out of one of the worst global economic downturns, drawing yet more attention to its promising and underexplored market as an attractive alternative for investors. Mindful of these developments and related opportunities, private equity investors have been deploying substantial funds in Brazil, fueling an unprecedented flow of countrywide M&A activity.⁵ The number of private equity deals that have taken place in M&A arena has increased by roughly 168% since 2007,⁶ and private equity investors have rapidly developed into one of the driving forces behind business ventures across a variety of industries.⁷

The above data helps put in perspective the rising magnitude of private equity investments in the Brazilian M&A context, a trend that is expected to be further amplified going forward.⁸ The data also suggests that private equity investments exert a

⁴ Since September 2009, when Moody's updated Brazilian government debt's rating to the investment grade category, Brazil's investment-grade status has been recognized by all the three major rating agencies. Standard & Poor's and Fitch Ratings elevated Brazil's rating to investment-grade in April and May 2008, respectively. Brazil is also rated investment-grade by the Canadian rating agency Dominion Bond Rating Service and by the Japanese agencies Rating and Investment Information and Japan Credit Rating Agency. See Public Debt Strategic Planning Department – Investors Relations, *Brazil Becomes Investment Grade by Moody's*, BRAZILIAN TREASURY (TESOURO NACIONAL) (2009), available at http://www3.tesouro.fazenda.gov.br/english/hp/downloads/Nota_Investment_Grade.pdf.

⁵ In a recent study on mergers and acquisitions in Brazil, PricewaterhouseCoopers reported an average of 384 announced transactions per year from 2002–2005, while the yearly average for 2006–2009 soared to 646 transactions. The yearly average further increased to 773 transactions announced from 2010–2012. See *Mergers and Acquisitions in Brazil*, PRICEWATERHOUSECOOPERS (Dec. 2012), <http://www.pwc.com.br/pt/publicacoes/servicos/assets/fusoes-aquisicoes/mea-in-brazil-december.pdf>. In 2009, Brazil hosted 79 of the 176 private equity transactions that took place in Latin America, channeling US\$2 billion of the US\$3.27 billion invested by private equity funds in the region. See Orlando Fernández, *Private equity in Latin America*, PRIVATE LAW COMPANY (PLC) (Sep. 21, 2010), available at <http://crossborder.practicallaw.com/9-503-3821>. Following this trend, in 2012, private equity and venture capital firms invested US\$7.9 billion in Latin America, according to the Latin American Private Equity and Venture Capital Association. See Vinod Sreeharsha, *Private Equity and Venture Capital Investments Rise in Latin America*, THE NEW YORK TIMES, DEALBOOK (March 5, 2013), <http://dealbook.nytimes.com/2013/03/05/private-equity-and-venture-capital-investments-rise-in-latin-america>. Accounting for US\$5.7 billion of the total channeled to the region, Brazil stands out as the country attracting the most money in Latin America. *Id.*

⁶ See *Mergers and Acquisitions in Brazil*, PRICEWATERHOUSECOOPERS, *supra* note 5.

⁷ These industries include food and beverages, real estate, information technology, health, education, energy, infrastructure, logistics, oil and gas, mining, reforestation and consumer products, among others.

⁸ Other factors supporting this trend include the steady improvement of local macroeconomic conditions and the overall investment climate, the rising liquidity of the Brazilian capital market, and the investment gap that exists in pivotal areas such as infrastructure, energy, health and education. See Rodrigo B. Feitosa, Fabio Terepins & Hermano Kemps, *Brazilian Private Equity: Moving Centre Stage*,

high degree of influence in the transformation of several sectors in the Brazilian economy, primarily by fostering the reallocation of assets and capital among entities and the reorganization of domestic businesses in pursuit of efficiency and profitability.

From a legal standpoint, the intensification of private equity activity has prompted investors and governmental authorities to come up with creative transactional structures and regulatory approaches to facilitate private equity ventures, while coping with the demands and challenges of an increasingly competitive market. The result of this interaction has been instrumental in reshaping the Brazilian M&A landscape.

M&A deal structures⁹ and market players in Brazil have evolved over the past ten years,¹⁰ and private equity sponsors catalyzed several of these changes.¹¹ This Article, however, focuses on one specific change: most M&A deals in Brazil involving private equity players have been undergoing an important DNA change stemming from the increasing use of the Brazilian Private Equity Fund (*Fundo de Investimento em Participações* (FIP)) on the buy-side and the sell-side of these transactions.

Unlike U.S. corporate law, Brazilian law does not provide for limited liability partnerships (LLPs) or limited partnerships (LPs), and until recently private equity investments in Brazil were predominantly structured through holding companies. These

INSEAD (Faculty & Research Working Paper, 2011), *available at* <http://www.insead.edu/facultyresearch/research/doc.cfm?did=48210>.

⁹ See *infra* the remainder of Part I for a description of typical deal structures and corporate entities more commonly employed in the context of private equity transactions carried out over the last decade.

¹⁰ Economies of scope and scale—other than those typically sought in M&A combinations—have become even more far reaching through arrangements permitting the management centralization of many targets and assets under a single investment conduit, putting the capital of its investors and the expertise of its service providers to the service of several companies, industries, and sectors. Exit strategies otherwise impracticable have become feasible through public or private offerings of securities due to a functional regulatory framework and an evolving capital market, which is capable of providing investors with liquidity to sell their stakes either through initial public offers (IPOs) or secondary offers. See Leonardo L. Ribeiro, Antonio Gledson de Carvalho & Claudio V. Furtado, *Private Equity and Venture Capital in an Emerging Economy: Evidence from Brazil*, 8–9 (Working Paper, 2006), *available at* <http://ssrn.com/abstract=912523>. Nine out of the sixteen Brazilian companies that went public on the São Paulo Stock Exchange (BM&FBOVESPA) between 2004 and 2005 were financed by private equity or venture capital investors. *Id.* at 8.

¹¹ Among such innovations, it is worth highlighting a set of measures enhancing governance standards and transparency in the Brazilian capital markets, including the protection of minority shareholders by means of a reduction of the proportion of preferred non-voting stock that may be issued in relation to common voting stock, tag-along rights to minority common stockholders at a price equal to eighty percent of the price paid to the controllers in case of a sale of control, the regulation of going private tender offers affecting takeovers and unsolicited bids, as well as the adoption of voluntary listing levels on BM&FBOVESPA (*Nível 1*, *Nível 2* and *Novo Mercado*), imposing on companies listed in such segments more stringent corporate governance standards than those required by Brazilian Corporation Law.

classic private equity transactions—formally implemented either through direct acquisitions/investments or via local holdings incorporated as a limited liability company (*sociedade limitada*¹²) or a corporation (*sociedade por ações (S.A.)*¹³)—are now gradually making way for structures involving domestic investment funds¹⁴ as the vehicle to acquire or invest in, hold, and manage portfolio companies until divestment is completed.

The most popular private equity vehicle in the Brazilian M&A practice is by far the FIP, whose structure bears some similarity to the partnership fund model generally adopted in the U.S. and in Europe. The Brazilian Securities and Exchange Commission (*Comissão de Valores Mobiliários (CVM)*¹⁵) introduced FIPs to Brazil through Rule No. 391 (CVM Rule 391/03), issued on July 16, 2003.¹⁶

By laying down the legal and regulatory grounds for the establishment of an investment conduit that local and foreign investors formerly lacked when sponsoring private equity ventures in Brazil, CVM Rule 391/03 largely contributed to a rapid expansion of FIPs in M&A deals.¹⁷ More importantly, investments and exit strategies

¹² The *sociedade limitada* is the type of Brazilian business organization that most closely mirrors the limited liability companies, limited partnerships, and closely held companies under U.S. and U.K. laws. They are currently the most common company form in the country, especially due to the flexibility accorded to the structuring of this type of business entity and the relatively low level of legal requirements and formalities to which it is subject under Brazilian law. For more information on *limitadas*, see PINHEIRO NETO ADVOGADOS, *Doing Business in Brazil*, Vol. 1, Chapter 2, F (2010).

¹³ The *sociedade por ações (S.A.)* is the type of Brazilian business organization that is similar to corporations and joint-stock companies under U.S. and U.K. laws. An *S.A.* can be publicly or privately held. A publicly held *S.A.* and its securities must be registered with the CVM, and its securities can be traded on the stock exchange or on regulated over-the-counter markets. The securities of a closely held company are not available to the general public. For more information on *S.A.s*, see PINHEIRO NETO ADVOGADOS, *Doing Business in Brazil*, Vol. 1, Chapter 2, G (2010).

¹⁴ The Brazilian regulatory framework encompasses a profusion of investment fund categories, each tailored to carry out investments in a particular asset class. As far as private equity investment is concerned, the equity funds that can be used are typically FIPs, Venture Capital Investment Funds (*Fundos de Investimento em Empresas Emergentes (FIEEs)*), focused on start-ups and small targets) and Stock Investment Funds (*Fundos de Investimento em Ações*, rarely adopted in part on account of regulatory constraints on portfolio composition).

¹⁵ Similar to the U.S. Securities and Exchange Commission, the *Comissão de Valores Mobiliários (CVM)* is a federal agency linked to the Ministry of Finance that is in charge of the regulation, development, control, and supervision of securities markets in Brazil, including FIPs, their investors, and quotas.

¹⁶ Instrução CVM [CVM Rule] No. 391, de 16 de julho de 2003, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 18.7.2003 (Braz.), as amended, [hereinafter *CVM Rule 391/03*].

¹⁷ As of December 31, 2012, there were 517 FIPs registered with the CVM, with a combined net equity of approximately US\$53.5 billion. See CVM's Register of FIP's Net Equity (*Cadastro de Patrimônio Líquido de FIP*) (Mar. 2013), available at <http://cvmweb.cvm.gov.br/SWB/Sistemas/SCW/CPublica/ListaPLFdoExcvFech/CPublicaListaPIFdoExc>

successfully implemented by FIPs since 2004 created an encouraging track record that helped Brazilian private equity-backed M&A transactions achieve high priority on the agendas of institutional investors.

The regulatory flexibility and generally favorable tax regime accorded to FIPs make FIPs a unique and powerful tool for structuring M&A transactions involving targets in Brazil. Additionally, investors can utilize FIPs for fundraising, deal financing, and implementing exit strategies, as applicable CVM regulations allow the placement of their units in the market. This Article illustrates the many ways in which private equity-backed M&A deals have undergone a DNA change in Brazil, derived—to a large extent—from the rise of FIPs as a common vehicle in such transactions.

II. THE BRAZILIAN PRIVATE EQUITY FUND (FIP)

CVM Rule 391/03 is the core regulation applicable to FIPs.¹⁸ The self-contained and investor-friendly legal regime applicable to FIPs makes FIPs the preferred and most flexible private equity vehicle in Brazil. The adaptability of the FIP allows investors to contractually stipulate the most suitable set of governance and operational rules that will govern the FIP itself and their legal interaction as owners of the vehicle. These rules are customarily amalgamated in the FIP's charter, investment commitment agreements, quotaholders agreements,¹⁹ and a variety of service contracts,²⁰ which regulate matters bearing on investment policy, decision-making procedures, capital commitments and calls, issuance and placement of units (quotas), distribution of proceeds, investment and

vFech.aspx?TPPartic=73. Nine out of the 517 FIPs currently registered with the CVM were under liquidation. Compared to FIPs, the use of Mutual Investment Funds in Innovative Emerging Companies (*Fundos Mútuos de Investimento em Empresas Emergentes Inovadoras* (FMIEEs)) is infrequent. As of the same date, only thirty-four FMIEEs were registered with the CVM (two of which were currently under liquidation), with an aggregated net equity of US\$376.3 million. See CVM Register of FMIEE's Net Equity (*Cadastro de Patrimônio Líquido de FMIEE*) (Mar. 2013), available at <http://cvmweb.cvm.gov.br/SWB/Sistemas/SCW/CPublica/ListaPLFdoExcVFeCh/CPublicaListaPIFdoExcVFeCh.aspx?TPPartic=72>.

¹⁸ FIPs are also governed by a specific regulation, Instrução CVM [CVM Rule] No. 409, de 18 de agosto de 2004, D.O.U de 24.8.2004 (Braz.), as amended (CVM Rule 409/04), which provides for the creation, management, operation, and disclosure of most Brazilian investment funds. This rule applies to FIPs on a supplementary basis, when its provisions do not contravene CVM Rule 391/03. FIPs are subject to Brazilian securities statutes but not to the Brazilian Corporation Law (Lei [Law] No. 6,404, de 15 de dezembro de 1976, D.O.U. de 17.12.1976, as amended).

¹⁹ FIPs held by more than one group of related investors or used as a conduit to implement joint ventures or associations between private equity investors and other strategic partners are often subject to quotaholders' agreements that regulate the participation of investors in the definition of the strategies and management policy of the FIP, including matters like the exercise of voting rights or control power, preemption rights, and purchase and sale of quotas at the FIP level.

²⁰ These service contracts include administration and portfolio management agreements, depository or custody agreements, and agreements with consultants, advisors, and industry experts hired by the FIP.

divestment periods, minimum net equity requirements, management and performance fees, and liquidation, among others.

2.1. Form and Ownership Structure

The FIP is, in essence, a collective investment vehicle formed as a *condominium*,²¹ allowing co-ownership of assets to be exercised among investors. FIPs can only operate in Brazil upon registration with the CVM, and FIPs, along with their securities (quotas) and investors (quotaholders), are subject to the CVM's oversight. The FIP must be organized as a closed-end²² *condominium* consisting of an un-personified pool of assets managed and represented by an administrator²³ registered with the CVM.

The FIP form can be especially attractive to private equity investors seeking lower individual exposure to risks through the gathering of funds by an investor pool and asset diversification.²⁴ The FIP can also provide its owners with a platform for centralized professional management of target companies with the requisite market and financial skills that otherwise would not be available to investors acting individually or through subsidiaries.²⁵ Additionally, Brazilian law requires the FIP to obtain a federal taxpayer number and to book the transactions it engages in on its own name and on its own behalf.²⁶

²¹ Under Brazilian law, a *condominium* can be defined as a joint property (*in rem*) right exercised by two or more persons over a certain asset or pool of assets, each holder (a co-owner or *condômino*) owning a *pro rata* fraction of such asset. The *condominium* itself has no legal personality apart from that of its owners, and the Brazilian Civil Code (Lei [Law] No. 10,406, de 10 de janeiro de 2002, D.O.U. de 11.1.2002 (Braz.), as amended) sets forth its central legal tenets. Statutes and regulations have elaborated on the legal concept of *condominium* to develop various legal structures, such as joint ownership of common areas of residential and commercial buildings and, most importantly for the purposes of this Article, quotas (securities) of mutual funds regulated by the CVM. For a further discussion of FIP's quotas, see *infra* section 2.2.

²² A mutual fund can be formed either as an open-end *condominium*, in which quotaholders can redeem their units at any time, or as a closed-end *condominium*, in which units can only be redeemed at the end of the funds' term, except in the case of liquidation of the fund. However, distributions can generally be made to quotaholders throughout the term of the fund and pursuant to its organizational documents. See *infra* section 2.9.

²³ See *infra* section 2.8.

²⁴ An FIP can be funded either publicly or privately, at the beginning of its operations or during its term of duration, and in a single offering or a series of offerings. The mix of alternatives available for FIP capitalization is further described in section 2.11.

²⁵ This feature is especially important in FIPs that invest in multiple target companies in the same industry, allowing quotaholders to benefit from economies of scale and scope that a centralized management structure and FIP-related efficiencies can provide.

²⁶ While the FIP is an un-personified entity under Brazilian civil law, tax regulations require the FIP to be registered with the National Register of Legal Entities (*Cadastro Nacional da Pessoa Jurídica* (CNPJ)).

2.2. Ownership Rights and Quotas

Equity units known as “quotas” represent the ownership interest rights of the FIP’s investors, or quotaholders.²⁷ Each quota in an FIP corresponds to a ratable share of the portfolio assets held under joint ownership by the quotaholders.²⁸ Thus, the value of each quota is calculated as the division of the net equity of the FIP by the number of outstanding quotas. Each quota carries one vote in the quotaholders’ general meeting,²⁹ unless the organizational documents of the FIP admit classes of quotas with different voting rights.³⁰

2.3. Permitted Investments

The FIP’s investment objectives primarily comprise the acquisition of stock, debentures, subscription warranties, or other securities convertible into or exchangeable for stock issued by publicly held (listed) or closely held corporations in Brazil, whose management must be actively monitored by the FIP. The remaining portion of the FIP’s portfolio can consist of liquid fixed-income instruments and other financial assets, mainly for cash management purposes.

The FIP’s charter must establish the eligibility criteria³¹ that apply to publicly held companies that the FIP invests in. These companies are also subject to the minimum set of corporate governance standards imposed by CVM Rule 391/03. Closely held companies that the FIP invests in have to comply with certain minimum governance guidelines such as (a) the establishment of a unified one-year term of office for the entire

²⁷ Resembling a limited partner (LP) in a U.S. partnership, the quotaholder of an FIP is the equity owner (co-owner) of a unit (quota) representing a fraction of the FIP’s net equity. According to the legal concept of *condominium* under Brazilian law, quotaholders of the FIP are not entitled to ownership rights over the securities and assets in its portfolio, but rather to the appropriate proportion of the total assets comprising the FIP’s portfolio and available for distribution.

²⁸ Section 2.9 discusses how FIP’s quotaholders are remunerated for their investment and the types of distributions they are entitled to receive from the FIP. FIPs having a sole quotaholder (exclusive FIPs) are also permitted, provided that such quotaholder is a qualified investor. *See infra* section 2.6.

²⁹ *See infra* section 2.8.

³⁰ If the FIP issues more than one class of quotas, each class can have distinct voting rights as defined by the FIP’s charter. This possibility allows the FIP to accommodate in its ownership base investors with contrasting profiles and interests, changing their level of involvement in the FIP’s governance and activities as particular deal circumstances may demand. Additionally, the FIP can attach to each class of quotas different economic rights, but exclusively in connection with the administration and performance fees relevant to each class and respective calculation bases. Consequently, the issuance of classes of quotas establishing different remuneration criteria among quotaholders of distinct classes is not permitted, which grants quotaholders an undivided right in the portfolio securities and assets of the FIP.

³¹ Frequently, such criteria are specified based either on those required under the voluntary listing levels on the São Paulo Stock Exchange (BM&FBOVESPA, *Nível 1*, *Nível 2* and *Novo Mercado*) or the minimum corporate governance standards imposed on closely held companies by CVM Rule 391/03.

board of directors (no staggered boards); (b) annual audit of their financial statements; (c) disclosure of related-party agreements, shareholders' agreements, stock option plans, and share buyback plans; and (d) the obligation to adhere to certain differentiated levels of corporate governance practices in case the company goes public.³²

Investments by the FIP in either closely or publicly held companies are not subject to minimum revenue or net worth requirements. There are no mandatory concentration or diversification requirements that apply to the allocation of the FIP's portfolio in equity investments, except if otherwise defined in the FIP's charter. The FIP can concentrate its entire net equity in a single target or distribute its investments in as many targets as decided on by the FIP's quotaholders or investment committee. Further, there are no restrictions on the number of FIPs that can invest in a single company.

2.4. Investment Restrictions

The FIP cannot invest in derivatives, except for hedging purposes. Furthermore, only the invested companies that make up the FIP's portfolio may hold direct ownership in real estate assets, not the FIP itself. Consequently, when FIPs are used to structure real estate investments, the invested companies held by the FIP are generally the ones either directly holding the real estate assets or investing in Special Purpose Companies (SPCs), which will then hold the real estate assets.³³ FIPs are not permitted to invest overseas.³⁴ Further investment restrictions include the prohibition from soliciting or contracting loans (except under very specific limited circumstances) and providing guarantees (except when approved by a qualified majority of 2/3 or more of the quotaholders in a general meeting and as expressly permitted by the fund's bylaws).³⁵ These restrictions constrain the FIP's ability to raise debt in the market to fund acquisitions or investments.³⁶ Nonetheless, holding companies or SPCs that the FIP invests in can be used as vehicles in leveraged acquisitions of, or investments in, target companies.

³² See CVM Rule 391/03.

³³ See *infra* section 2.5 and Figure 1 (FIPs, Target Companies and SPCs).

³⁴ According to article 35, item VI(a) of CVM Rule 391/03, all companies comprising the FIP's portfolios must be incorporated and headquartered in Brazil. Despite the growing internationalization of M&A transactions and the demand from local institutional investors for such flexibility, the CVM has not changed this rule.

³⁵ See art. 35, items II e III, of CVM Rule 391/03.

³⁶ This differs from the leveraged buyout structures that are common in private equity-sponsored M&A deals in the U.S.

2.5. Special Purpose Companies (SPCs)

While companies in which the FIP invests must be publicly or closely held corporations, prevailing regulations impose no restrictions as to the type of business organization of the SPCs that can be held by target companies (*S.A.s*) directly owned by the FIP. As Figure 1 depicts, the FIP can use these SPCs—through target companies—to channel private equity investments in equity participations and assets that would otherwise not be permitted at the FIP level,³⁷ which creates liability-shields for the FIP's quotaholders.³⁸

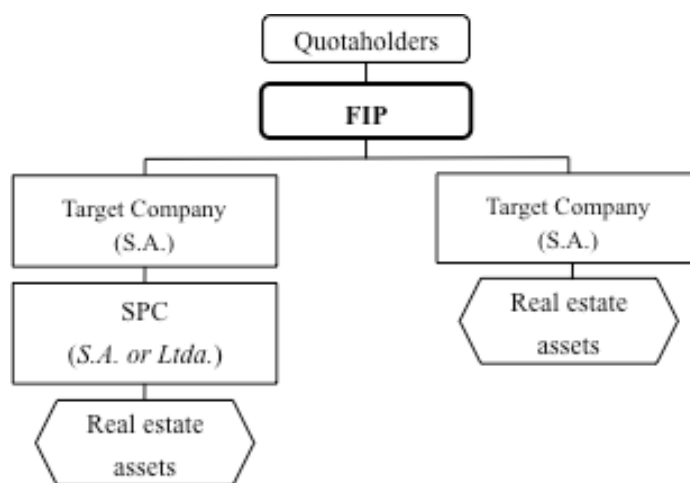


Figure 1 – FIPs, Target Companies and SPCs

Peculiarities pertaining to target or asset acquisitions, costs, time, tax efficiencies, and regulatory implications may be some of the motivations that lead corporate planners to adopt multiple corporate layers under an FIP, like the ones exemplified in Figure 1.

³⁷ See *supra* section 2.4.

³⁸ Under Brazilian Corporation Law, the liability of an FIP with respect to an SPC or any other invested target company is generally limited to the unpaid portion of the issuance price of such SPC's or target company's shares (that is, the portion subscribed for but not yet paid in by the FIP). Once the FIP pays in the shares of the SPC or the target company, the FIP and its quotaholders are no longer responsible for any liabilities in connection with companies held in its portfolio, except in very limited circumstances. These limited circumstances include, for example, liabilities associated with acts perpetrated with fault or willful misconduct and in violation of the law or the target companies' organizational documents, and instances where the application of the disregard of legal entity doctrine can be applied under Brazilian law.

2.6. Eligible Investors

The risks associated with private equity investments generally make such investments unsuitable for the general public. As for FIPs specifically, typical risks involve: (a) illiquidity of the securities and assets making up the FIP's portfolio (as opposed to other investments in more liquid asset classes); (b) concentration in securities issued by only a few target companies or by target companies pertaining to given industries or sectors; (c) failure to comply with the investment policy due to the lack of eligible targets; (d) other risks particularly related to the target companies, including a spectrum of business, financial, and legal risks and contingencies; (e) risks related to the management and operation of the FIP; and (f) market and credit risks.³⁹ CVM Rule 391/03 acknowledges these risks concern and limits investment eligibility in FIPs to investors whose financial capabilities and sophistication enable them to make informed investment decisions.⁴⁰ CVM Rule 391/03 also sets at R\$100,000 (approximately US\$43,000 as of November 2013) the minimum capital commitment in the FIP per quotaholder.⁴¹ Hence, only "qualified investors" as defined by the CVM, can acquire the quotas of an FIP.⁴² This target investor restriction gives private equity investors great latitude to structure FIPs and regulate their operation according to the rules suited for each particular deal or set of deals.

Among local qualified investors, pension funds have been one of the most active players in the domestic private equity scenario.⁴³ Non-resident investors must make the required investment in accordance with the rules of Resolution No. 2,689, issued by the National Monetary Council (CMN) on January 26, 2000 (CMN Resolution 2,689/00),⁴⁴

³⁹ Additionally, equity losses incurred by the FIP's quotaholders are not limited to the subscribed capital, meaning that they may be called to make extraordinary capital contributions to the FIP in cases where the assets available are not sufficient to fulfill liabilities arising from target companies.

⁴⁰ See CVM Rule 391/03.

⁴¹ See *id.*

⁴² The definition of "qualified investors" includes the following investors: (a) financial institutions; (b) insurance companies and special savings companies (*sociedades de capitalização*); (c) open- and closed-end pension funds; (d) individuals or legal entities with financial investments that hold financial investments in excess of R\$300,000 (roughly US\$130,000) and that attest in writing their status as qualified investors; (e) investment funds exclusively targeted to qualified investors; (f) portfolio managers and securities consultants authorized by the CVM, in relation to their own funds; and (f) social security regimes instated by the Federal Government, States, Federal District or Municipalities. See CVM Rule 409/04, art. 109.

⁴³ Pension funds became one of the most active players in the domestic private equity scenario mainly after the National Monetary Council (CMN) recognized private equity as a separate asset class and allowed closed pension funds (*Entidades Fechadas de Previdência Complementar*) to invest up to twenty percent of their portfolios in quotas of FIPs. See Resolução CMN [CMN Resolution] No. 3.792, de 24 de setembro de 2009, D.O.U. de 28.9.2009 (Braz.), as amended.

⁴⁴ See Resolução CMN [CMN Resolution] No. 2.689, de 26 de janeiro de 2000, D.O.U. de 27.1.2000

which apply in addition to the prerequisites of CVM Rule 391/03. CMN Resolution 2,689/00 basically allows non-resident private equity investors to remit funds into Brazil to subscribe for and pay in FIPs' quotas and repatriate their capital abroad.⁴⁵

2.7. Active Participation in the Management of Target

CVM Rule 391/03 requires the FIP to actively participate in the invested companies' strategic policies and management, notably by appointing members to their boards of directors.⁴⁶ The requirement to actively participate in the decision-making process of the target companies and influence their strategy and management is one of the core features that make FIPs especially attractive to private equity investors. Whatever form the FIP investment in a target company takes,⁴⁷ under CVM Rule 391/01, the FIP must retain some degree of effective influence in the invested companies' strategic decisions.

In order to satisfy the investment eligibility test, the FIP may: (a) hold stocks that are part of the controlling block of the invested company; (b) enter into shareholders' agreements granting it decision powers over the invested company; or (c) enter into other agreements or arrangements that ensure the FIP's actual influence on the strategic policy and management of the invested company (agreements or arrangements of this sort can entail, for example, veto rights and supermajority quorums).

2.8. Management and Governance

In contrast to the partnership structure of many U.S. private equity funds, the administration, portfolio management, and distribution of equity interests of an FIP are not performed by a general partner but rather by an independent legal entity accredited with the CVM to engage in securities portfolio administration activities: the so-called FIP administrator (*administrador*).⁴⁸ The administrator is responsible for the legal representation of the FIP as well as for managing the FIP's routine activities, which

(Braz.), as amended.

⁴⁵ For the purpose of foreign capital registration with the Central Bank of Brazil, the FIP must be registered with the CVM, and its quotas must be tradable either on the stock exchange or organized over-the-counter market. *See* art. 6 of CMN Resolution 2,689/00.

⁴⁶ *See* CVM Rule 391/03.

⁴⁷ Forms that the investment may take include a control acquisition, minority participation, or joint venture, *inter alia*.

⁴⁸ The functions of both the FIP's administrator and portfolio manager (*gestor de carteira*) may be performed by the same legal entity. Alternatively, the FIP's administrator may retain an equally qualified third party to manage the portfolio of the FIP. The administrator and the portfolio manager can be held liable for losses borne by the quotaholders if they act with fault or in violation of the law, the CVM rules, or the FIP's charter.

include paying fees, receiving dividends and interest, preparing financial statements and reports, signing shareholders' agreements of companies in which the FIP is a shareholder, providing reports and information to investors, in addition to other activities established in the FIP's charter or determined by the quotaholders' general meeting.

The quotaholders who attend the general meeting are the key decision-makers in an FIP and have exclusive authority over key matters such as the amendment of the charter, the removal of the administrator, the merger or liquidation of the FIP, the issuance and distribution of new quotas, the extension of the duration of the FIP, and the operation of the committees and administrative bodies of the FIP. Resolutions of the general meeting generally require a majority vote of the attendees, unless a supermajority vote is mandated by CVM Rule 391/03 or by the FIP's charter.

Certain FIPs also have internal committees and boards to enrich their decision-making processes and to ensure informed decisions regarding the FIP's investments and divestitures.⁴⁹ More complex FIPs might also have advisory boards and technical committees to advise on matters pertaining to the industry or sector of each target company.⁵⁰

2.9. Distributions and Dividends, and Investment and Divestment Periods

While investors of mutual funds organized as open-end mutual *condominia* can have their quotas redeemed at any time, quotaholders of closed-end mutual funds like FIPs are only entitled to redeem their quotas at the end of the FIP's term, and thus remain locked-in for the entire term of the FIP. Nevertheless, the FIP is allowed to make recurring distributions (*amortizações*) to its quotaholders during the term of the FIP. An FIP may divest itself of one or more of its portfolio companies and distribute the sales proceeds to its quotaholders without having to wait until the termination of the FIP. It may also reinvest such proceeds in other targets, subject to the applicable provisions of the FIP's charter.⁵¹ Additionally, if the FIP's charter allows its quotaholders to receive

⁴⁹ These internal bodies are more relevant in FIP structures where the investors have a passive or secondary role in defining investment policies. As a result, in many instances investors prefer to entrust the details of portfolio management of an FIP to groups of private equity professionals, business developers, industry experts or technicians who are also empowered to follow up on the performance of the FIP's investment portfolio and the administrator's activities vis-à-vis its obligations to the FIP.

⁵⁰ Supervisory boards have become more common in the FIP business due to the rules recently introduced by the Governance and Best Practices Code for Private Equity Funds (FIPs) and Emerging Companies Investment Funds (FIEEs), which state that such boards are to oversee investment decisions made by the investment committee whenever conflicts of interest arise between quotaholders and the FIP's administrator or portfolio manager.

⁵¹ Normally, distributions occur only after the expiration of the investment period defined in the FIP's charter. The investment period often goes from the inception of the FIP until two or three years after, and

dividends from companies in which the FIP has invested, such dividends may be distributed directly by the target company to the FIP's quotaholders, ratably according to their respective ownership interests in the FIP.

Quotaholders also have the right to terminate the FIP at any time by qualified majority voting at a meeting, even during the investment period. This right is usually exercised by quotaholders when the FIP has disposed of all of the securities and assets in its portfolio before the end of the FIP's term of duration or in situations where the FIP has not been able to find eligible target investments.

2.10. FIP Registration and Reporting Requirements

FIPs must be registered with the CVM in order to operate and are subject to continued scrutiny by the CVM.⁵² The CVM imposes flexible and relatively simple conditions for registration of FIPs. When an investment channels through an FIP, the CVM requires that the FIP regularly report information about its financial standing and performance, including general information about its portfolio. Other than these CVM reporting requirements, there are no disclosure obligations affecting private equity investments, except for the Central Bank of Brazil's reporting requirements, which are applicable to foreign investments entering Brazil, and the disclosure requirements that may be imposed by local antitrust authorities. However, if the company is or becomes listed, it must then comply with several disclosure and publicity requirements under Brazilian law.⁵³

2.11. Offering of Quotas

The distribution of FIPs' quotas is considered a public offering of securities under Brazilian securities laws and regulations⁵⁴ and, as such, is subject to prior registration with the CVM. If an FIP's quotas are to be distributed to the public, the requirements set forth in CVM Rule No. 400, of December 29, 2003 are triggered.⁵⁵ Nonetheless, under

during this period FIP is expected to undertake investments and deploy funds in target companies in fulfillment of its investment policy. Distributions may also be made in kind, such as in assets, rights, or securities, as long as the relevant distribution rules have been previously agreed upon and are stipulated in the FIP's charter.

⁵² Registration is generally granted within five business days from the filing of the proper documentation with the CVM.

⁵³ See Instrução CVM [CVM Rule] No. 400, de 29 de dezembro de 2003, D.O.U. de 9.1.2004 (Braz.), as amended.

⁵⁴ See, e.g., art. 26 of CVM Rule 391/03.

⁵⁵ In this case, the FIP must submit the CVM filing, along with a detailed prospectus, notices, and marketing materials for underwriters and offering participants to use in the public offering, as well as statements signed by the FIP's administrator and the offering's underwriter in connection with the legality

Rule No. 476, issued by the CVM on January 16, 2009 (CVM Rule 476/09),⁵⁶ a fast-track procedure applies to certain restricted placements.⁵⁷

2.12. Taxation of FIP and its Quotaholders

FIPs are generally exempt from income tax on the gains derived from their financial investments because of the FIP's characterization as a *condominium* under Brazilian law. In contrast, Brazilian tax law does not treat the Brazilian target companies in which the FIP invests as tax-transparent and instead taxes them as independent entities. The fact that the FIP itself is *per se* exempt from taxation on acquisitions and divestitures makes it a very attractive vehicle for private equity investment. Further, the tax treatment accorded to non-resident quotaholders of FIPs give them an extra incentive to employ such vehicles.

Dividends received by the FIP and repaid to its quotaholders are currently not subject to the Brazilian withholding income tax (WHT). Interest on net equity⁵⁸ received by the FIP and repaid to quotaholders as well as other payments made to FIP's quotaholders domiciled in Brazil are subject to WHT at the rate of fifteen percent.⁵⁹ However, WHT assessed on the income earned by non-resident investors arising from an interest in an FIP as well as upon repatriation of the capital originally invested in the FIP are currently subject to a zero percent rate,⁶⁰ provided that certain conditions are met.⁶¹

of the offering and the truthfulness of the information then provided to the public. *See* Instrução CVM [CVM Rule] No. 400, de 29 de dezembro de 2003, D.O.U. de 9.1.2004 (Braz.), as amended.

⁵⁶ *See* Instrução CVM [CVM Rule] No. 476, de 16 de janeiro de 2009, D.O.U. de 19.1.2009 (Braz.).

⁵⁷ In restricted placements, a maximum of fifty potential investors are initially approached and no more than twenty investors ultimately subscribe quotas of the FIP. *See* art. 3, item I, of CVM Rule 476/09. Moreover, the FIP's quotas offered under CVM Rule 476/09 are subject to a ninety-day lock-up, which begins with their subscription or acquisition by the respective investor, *see* art. 13 of CVM Rule 476/09, and the FIP cannot carry out another public offer of quotas within four months from the date of termination of the last offer, unless such new offer is submitted for registration by the CVM. *See* art. 9, of CVM Rule 476/09.

⁵⁸ Under Brazilian law, interest on equity (*juros sobre capital próprio*) is essentially a tax-deductible payment, made by corporations to their shareholders, of a notional interest rate calculated by the application of a long-term interest rate over the company's capital stock.

⁵⁹ *See* art. 25 of Instrução Normativa [Rule] No. 1,022, de 5 de abril de 2010, D.O.U. de 7.4.2010 (Braz.), as amended, and art. 2 of Lei [Law] No.11,312, de 27 de junho de 2006, D.O.U. de 28.6.2006 (Braz.) (Law 11,312/2006).

⁶⁰ *See* art. 3 of Law 11,312/2006.

⁶¹ In order to enjoy such tax benefits, the following conditions must be met: (a) the FIP's quotaholder cannot hold—individually or jointly with related persons—quotas representing forty percent or more of all the FIP's quotas or forty percent or more of the total income of the FIP; (b) the FIP cannot hold in its portfolio debt securities exceeding five percent of the FIP's net equity; and (c) the foreign investor cannot be resident or domiciled in a country defined by Brazilian law as a tax haven jurisdiction (a country where income is not taxed or subject to taxation at a maximum rate lower than twenty percent). *See id.*

This exemption partly explains why foreign private equity feeder funds and other non-resident investors usually treat FIPs as the preferred vehicles for private equity investments in Brazil.

Savings from a zero reduction on the WHT levied on income distributions made by the FIP may be crucial to determining the economic advisability of an M&A transaction and allow private equity investors to maximize the value-capturing potential of certain opportunities.⁶² As the FIP itself is a tax neutral entity (pass-through vehicle), even resident investors take this factor into consideration when structuring M&A deals, with the intent to defer taxes at least for the term of the FIP.

2.13. FIP Structure

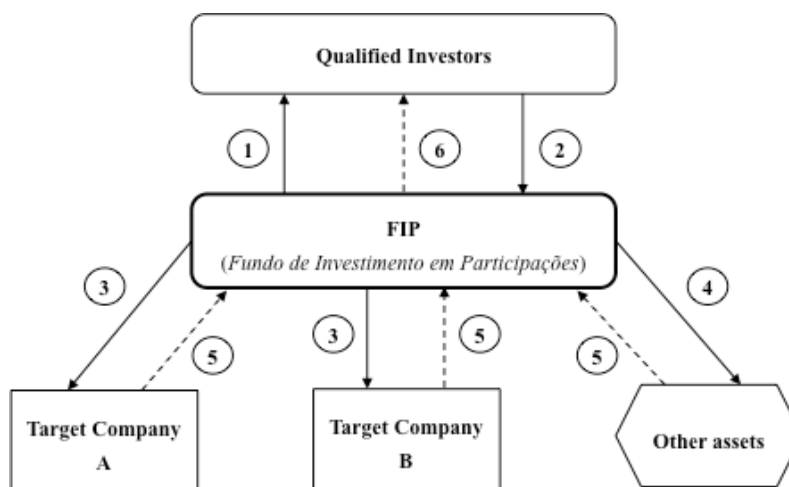


Figure 2 – Standard FIP structure and payment flows

Figure 2 shows a standard FIP structure and the payment flows typically carried out among transaction participants, as enumerated below:

1. FIP issues quotas to Qualified Investors;
2. Qualified Investors subscribe and pay quotas to the FIP;
3. During the investment period, the FIP invests the amounts raised through the offering of its quotas in securities of one or more target companies;
4. The remaining net equity of the FIP is invested in other assets and securities

⁶² From a deal perspective, a positive side effect of this mutually beneficial “increase in the pie” is to induce private equity investors—as owners and controllers of the FIP—to take a more risk-seeking approach towards the closing of M&A transactions in Brazil that would otherwise not be feasible.

authorized under the FIP's charter;

5. Proceeds arising from payments of dividends and interest on equity by target companies, sales of other assets and securities comprising the FIP's portfolio, and other distributions are disbursed to the FIP normally following the expiration of the FIP's investment period; and

6. The FIP makes distributions to quotaholders.

III. CONCLUSION

Brazil has become a preferential stop for private equity sponsors seeking high returns from investments in local target companies. The surge of private equity investments carried out in Brazil over the past decade had two major ramifications. First, it powered an unmatched flow of M&A activity across nearly all business sectors of the Brazilian economy. Second, it fostered a revamp of the legal and regulatory framework of private equity-backed ventures in Brazil.

From a legal perspective, the measures that Brazilian authorities adopted primarily focused on making available to local dealmakers cutting-edge tools, features, strategies, and structures that private equity sponsors and conduits generally employ in the international M&A arena. In this context, FIPs came to light in 2003, in a clear attempt to facilitate private equity investments and to adapt to an increasingly competitive market for transnational business combinations. CVM Rule 391/03 tailored FIPs so as to meet such demands, not surprisingly making them the most successful private equity vehicle in Brazil.

As FIPs gain prominence, the classic private equity investment model⁶³ that prevailed until the late 1990s is rapidly losing ground in Brazil, as are the tools, features, strategies, and structures associated with this deal wave. The benefits of FIPs outweigh corporate-based structures by encompassing more flexibility, less bureaucracy, lower transaction costs, and more tax efficiencies. Moreover, FIPs can also provide synergies as domestic hubs of private equity investments in a diversified portfolio of target companies and can finance such undertakings through the placement of quotas.

The foregoing scenario converges in what this Article claims to be a DNA change in Brazilian M&A deals. Part II addressed the role that FIPs are playing in this process and highlighted the regulatory stability and structuring possibilities introduced by CVM Rule 391/03 that are largely contributing to a swift expansion of such conduits in the Brazilian M&A practice.⁶⁴ Some of the distinguishing features of FIPs discussed in Part

⁶³ See *supra* Part I.

⁶⁴ The investments and exit strategies successfully implemented by FIPs since 2004 likewise created

It also supports the conclusion that their widespread use is reshaping the Brazilian M&A landscape. As the roster of reasons supporting this proposition is extensive, it suffices to recapitulate here that the adaptability of FIPs to a wide range of transactional circumstances and requirements, coupled with the favored tax regime accorded both to the fund itself and to its quotaholders, increasingly make FIPs the most suitable structuring option for private equity-sponsored M&A deals in Brazil.

Taking advantage of the investor-friendly legal and regulatory regime accorded to FIPs, private equity investors have found in the FIP form great latitude to engage in domestic M&A transactions. Moreover, private equity investors are now able to influence the management of target companies according to the rules that they consider more suitable for each given deal. This DNA change in Brazilian M&A deals has optimized the investment landscape to the benefit of the investor. In sum, the ongoing boom of M&A transactions involving private equity sponsorship through FIPs means that M&A practitioners should familiarize themselves with FIP structures so as to stay ahead of the legal curve in the rapidly evolving Brazilian investment landscape.

an encouraging track record that stimulated the propagation of FIPs among foreign institutional investors seeking opportunities in emerging markets.