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Brazilian Private Equity &
Venture Capital Association

Legal Structure

Private Equity and Venture
Capital Funds in Brazil



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Coordination:
Ângela Ximenes
Executive Manager

Gabriela Sant'Anna
Press and Communications Officer

Content:
TozziniFreire Advogados

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President Foreword

This is the first edition of a new legal series published by ABVCAP and its members, which aims to gather and disseminate information on the regulatory framework of Brazil's private equity, seed and venture capital industry.

In spite of the global financial crisis, investments in Brazil's seed, private equity and venture capital have been growing steadily. This growth is fundamental for the strategic development of domestic companies and for the growth of capital markets.

If on the one hand, new independent fund managers arrive in the market, on the other, international investors are also attracted to seek new opportunities in our country. These groups are raising some questions about the Brazilian legal framework, which we hope to answer through this series. Some of these questions include more details on the FIP - Fundos de Investimentos em Participações (Funds for Investment in Participations) and FMIEE - Fundos Mútuos de Investimentos em Companhias Emergentes (Funds for Investment in Emerging Companies), which are regulated and supervised by the CVM - Comissão de Valores Mobiliários, the Brazilian Securities and Exchange Commission. In addition to a simple and clear overview of these investment vehicles, this edition also clarifies the obligations, duties and liabilities of fund managers and administrators.

With this publication, ABVCAP aims to disseminate an important tool to help not only investors, fund managers and administrators, but also scholars and researchers interested in learning more about this asset class.

This guide, elaborated both in English and in Portuguese by TozziniFreire Advogados, a member of the Association, represents another step towards the improvement of responsible investment practices, together with the ABVCAP/ANBIMA Code of Regulations and Best Practices, issued in 2011, and with the Guide of Venture Capital and Private Equity developed by the Executive Committee of Institutional Investors of ABVCAP, published in 2013.

Our next edition of this Series will approach the fiscal aspects applied to these investment vehicles, thus contributing to facilitate access to qualified information and to accelerate investments in innovative companies.

We deeply appreciate TozziniFreire Advogados' contribution and express our thanks to its private equity team.

Clovis Meurer
President

Private Equity Funds and Venture Funds in Brazil

1. Brazilian Investment Funds Overview

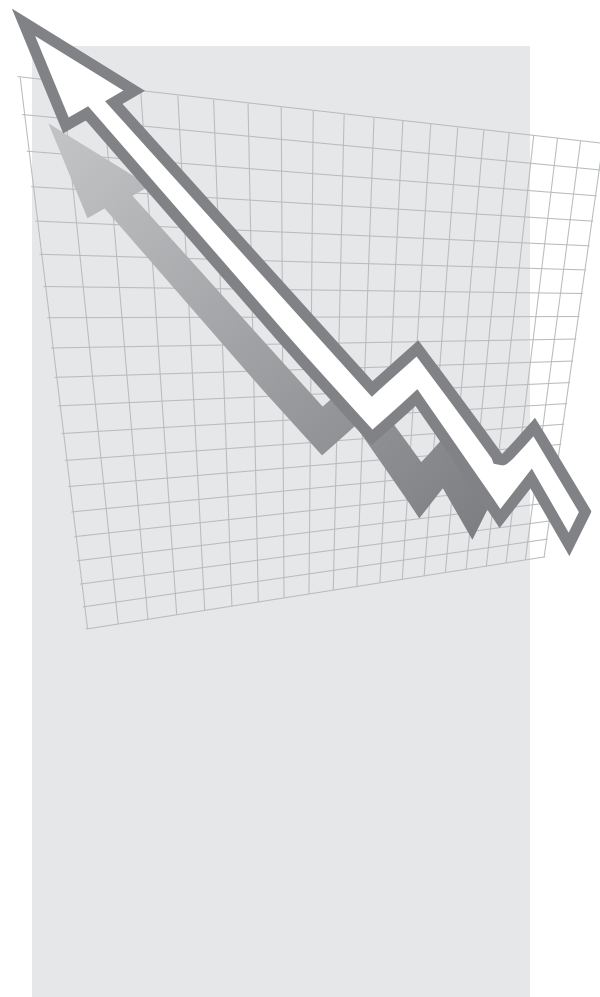
Under Brazilian legislation, investment funds are organised as a pool of assets jointly owned by the funds' shareholders under the structure of a co-property (condominium). There is no corporate structure behind pools of assets held by means of an investment fund structure, in spite of the fact that they can assume the duties and obligations towards third parties, and they can sue and be sued.

This means that investors in Brazilian investment funds are holders of shares that represent their co-investment in the assets that belong to the investment funds.

The investors' interest in an investment fund are called 'quotas', which can be described as a share. The ownership of the fund's shares does not grant investors direct ownership of the fund's assets meaning that investors generally have rights over the whole fund's portfolio proportionally to the number of shares held by each investor.

Administrators of investment funds are generally legal entities that comply with Rule 306, enacted by the Brazilian Securities Commission (CVM) dated as of May 5, 1999, as amended (CVM Rule 306/99), and are duly authorised by CVM to provide securities portfolio management services, according to Law N. 6,385, dated as of December 7, 1976 (Law N. 6,385/76). Portfolio managers, which, by and large, can either be a person or a legal entity, also have to comply with CVM Rule 306/99 and have to be previously authorised by CVM.

The fund's by-laws will stipulate the administrator's remuneration as well as whether the fund will pay a



performance fee to the portfolio manager. The administration and performance fees are usually established as carried interest, through which the administrator will receive a share of the net assets annually accounted for the investment fund. From the amount established for the administration and performance fees, the administrator shall deduct the fee of the portfolio manager and the remuneration of other service providers, unless otherwise determined in the by-laws.

Generally speaking, the following documents must be filed by the relevant administrator prior to the operation of a fund: (a) the fund's formation document which is obtained through a resolution by the fund's administrator; (b) the fund's by-laws; (c) registration forms concerning the fund's administrator, portfolio manager and other providers of services retained by the fund; (d) disclosure of documents used for the distribution of shares; and, as the case may be (e) the prospectus.

With respect to investment funds focused specifically in equity participations, they were initially regulated by CVM in 1994, through the introduction of Funds for Investment in Emerging Companies (FMIEE). Rule 209 enacted by CVM dated as of March 3, 1994, as amended (CVM Rule 209/94) addressed only investments in emerging companies, with limited characteristics and purposes. The initiative, therefore, did not benefit those investors that intended to use a fund structure to invest in companies with other characteristics.

It was only in 2003 that the CVM regulated private equity funds, known in Brazil as Fundo de Investimento em Participações (FIP), through Rule 391, enacted by CVM on 16 July 2003, as amended (CVM Rule 391/03).

2. Private Equity funds

In Brazil, one of the most important types of investment funds are the FIP. These funds are governed by CVM Rule 391/03 and, according to this rule, they are considered closed-ended funds. Such rule regulates the formation, operation and winding up of private equity funds.

The purpose of a FIP is to buy shares and securities convertible into shares issued by Brazilian corporations, which can either be closely-held corporations (unlisted companies) or publicly traded corporations (listed companies). They must allocate and maintain at least 90% of its net worth in the above-mentioned assets.

The investment period of the FIP will be determined in its by-laws, which may be shortened or extended by the shareholders. Investments must also comply with the fund's investment policy. Otherwise, the administrator or the portfolio manager may be held liable for losses suffered by the fund. Private equity funds are not covered by any form of deposit insurance.

In addition, the term (i.e. duration) of a FIP, as well as the possibility of early terminating a FIP, are also contemplated in the FIP's by-laws. However, the decision to terminate early a FIP has to be approved at a shareholders' meeting and will become effective only after registration of a copy of the relevant minutes of this shareholders' meeting with the CVM.

The FIP's shares must be targeted at qualified investors which, according to Rule 409 enacted by CVM dated as of August 18, 2004, as amended (CVM Rule 409/04), are financial institutions, pension funds, insurance entities, individuals or legal entities with investments in the financial and capital markets in excess of R\$ 300,000.00 and investment funds directed at qualified investors and asset managers and dealers, with a minimum value of subscription of R\$ 100,000.00. Considering that private equity funds' shares are exclusively targeted at qualified investors, they may only be sold in the secondary market if the relevant purchaser is also a qualified investor.

As a general rule, CVM Rule 391/03 provides that FIP must have a significant influence in the decision making process of the companies. Notwithstanding the above, CVM Rule 391/03 fails to establish an accurate meaning for "significant influence in the decision-making process". It only provides examples on how the FIP may ensure its rights to effectively influence decisions relating to the strategic policies and management of the companies, which could be either by holding controlling shares or by entering into any shareholders agreement or any procedure that ensures their effective influence in the management of the company's strategic policy or by appointing the members of the board of directors.

In the case of investments in closely-held corporations (unlisted corporations), the relevant by-laws must be adapted, to the extent necessary, in order to comply with the following corporate governance requirements and practices set forth in CVM Rule 391/03: (a) prohibition of the issuance of founders' shares (partes beneficiárias), as well as cancellation of any existing founders' shares; (b) define a unified term of office of 1 year for the entire board of directors; (c) disclosure of (a) any agreements entered with related parties, (d) any shareholders agreements, (e) stock option programs or any issuer's security option program; (f) if it decides to become a publicly held corporation, it must undertake, before the fund, to adhere to a stock exchange's or organised OTC market's special corporate governance segment; (g) adopt arbitration as the conflict/dispute resolution mechanism; and (h) annually audit its financial statements by an independent auditor registered with CVM.

Moreover, the FIP's administrators must periodically provide documents and information CVM on a monthly, semi-annual and annual basis. The most common information among the different types of investment funds are: (a) the fund's net worth and the number of shares issued; (b) the fund's portfolio composition and diversification; (c) balance sheet; (d) profile of investment; and (e) financial statements.

The FIP's administrators must also inform CVM and immediately disclose any material act or fact that relates to the operation of the funds or the assets comprising their portfolio by letter to all shareholders. By doing so, it will allow all shareholders or prospective investors to access information that may reasonably influence the share price or the investors' decision to buy, sell or keep these shares. Private equity funds must have their respective assets valued and priced according to provisions described under their relevant by-laws.

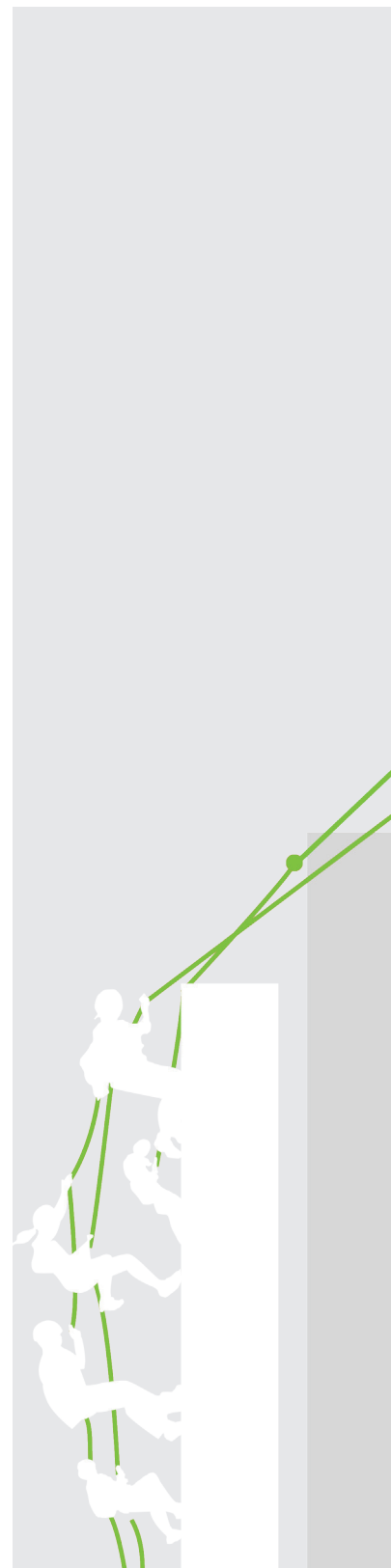
CVM Rule 391/03 was subject to important changes in the year of 2013 brought by Rule 535 enacted by CVM dated as of June 28, 2013 (CVM Rule 535/13) and Rule 540 enacted by CVM dated as of November 27, 2013 (CVM Rule 540/13).

CVM Rule 535/13 provided that, if permitted in the fund's by-laws, the administrator may provide a personal guaranty (fidejussory guarantee) on behalf of the fund, subject to the approval by a qualified majority of the shareholders, limited to a minimum of 2/3 of the shareholders, at a shareholders' meeting.

CVM Rule 540/13 changed CVM Rule 391/03 in order to bring flexibility to the general requirement that FIP must have significant influence in the decision making process of their invested companies, provided that the investments are made in companies listed in the access market with higher corporate governance standards than required by law, aiming at incentivising FIP to invest in these companies. This rule allows FIP to invest up to 35% of their net worth in companies without the requirement of significant influence in the decision making process of these companies. This limit of 35% shall be increased to 100% during the 6-month investment period after each opportunity the shares of the FIP are paid up by its shareholders. Also, this limit of 35% does not apply during the fund's disinvestment period with regard to each of the invested companies.

Also private equity funds cannot leverage through borrowing. According to Rule 406 enacted by CVM dated as of January 16, 2009 (CVM Rule 406/09), FIP are allowed to receive financial support from financial agencies with the ability to obtain loans to leverage their investments in amounts up to 30% of the assets which form their investment portfolios. Such loans may only be granted by multilateral organizations, development agencies or development banks (such as the Brazilian Bank for Economic and Social Development (BNDES) and the Interamerican Development Bank (IDB)) whose funds are provided mostly by a single or multiple governments, and controlled by one or multiple governments.

The FIP is an excellent debt restructuring instrument for companies undergoing a judicial restructuring. A FIP can be structured to acquire interest in these companies, and the FIP's shareholders may have the right to pay for their shares with assets or rights, including credits associated with the restructuring process of the target company.



3. Venture Capital Funds

The venture capital funds in Brazil are known as Funds for Investment in Emerging Companies (FMIEE), created and regulated by CVM Rule 209/94. Such funds are considered closed-ended funds and its term is up to 10 years (CVM Rule 209/94, Article 2).

The FMIEE must invest in emerging companies as described by Rule 470 enacted by CVM dated as of May 6, 2008 (CVM Rule 470/08), which consists of enterprises with an annually net revenue, or an annually consolidated net revenue, of less than R\$ 150 million, calculated based on the closing balance sheet of the last fiscal year preceding the acquisition of securities issued by the company. This R\$ 150 million limit should only apply to the first acquisition of securities issued by the company and not in relation to new shares (of the same company) subscribed or acquired by the FMIEE. Notwithstanding the above, the fund is not allowed to invest in a company that is part of a group of companies with a consolidated net worth that exceeds R\$ 300 million.

The administrator of a FMIEE could be either an individual or a company duly authorized by CVM. Unlike the FIP's administrator, the administrator of a FMIEE may not provide any personal guaranty, or figure as a co-obligor of the fund in any other way.

A FMIEE must invest at least 75% of its net worth in shares, debentures convertible into shares or subscription warrant of shares issued by emerging companies. The remaining of its net worth shall be invested only in shares of fixed income funds or fixed income securities, selected by the administrator, or invested in securities of public companies acquired in stock exchange or over-the-counter markets.

In addition, the full payment of the fund's shares must take no more than 360 days after the registration of the fund with CVM regarding the distribution of the fund's shares or, in case of private distributions, after the authorization of the fund's formation. The value of each of the fund's shares shall be equal to or more than R\$ 20,000.00.

Rule 477 enacted by CVM dated as of January 28, 2009 (CVM Rule 477/09) allows the use of derivatives for hedging purposes of the investment portfolio as well as the extension of the term of the FMIEE if approved by the majority of the shares issued by the fund at a shareholders' meeting.



4. Taxation of FIP and FMIEE

Due to the fact that investment funds are deemed to be a condominium, as mentioned above, in general, its portfolio is exempt from Brazilian taxes (such as corporate income tax or social contributions) until income is distributed to its shareholders. In general, investment funds are exempt from withholding tax (WHT) on any income obtained from their investments.

Any gains obtained upon sale or redemption of shares of FIP and FMIEE, by investors resident in Brazil, are generally subject to withholding tax at a 15% rate. However, where FIP and FMIEE do not hold a portfolio comprising at least 67% of stocks of corporations, convertible debentures or subscription bonuses, it will be treated as a fixed income investment and thus subject to income tax at rates ranging from 22.5% to 15%, depending on the term of the investment.

Brazilian regulation allows foreign investors to invest in the same financial products as the ones available for Brazilian investors (including FIP and FMIEE), as long as the foreign investor is duly registered with CVM. Non-resident investors are generally subject to the same taxation as resident investors. However, non-resident investors that invest in shares of FIP and FMIEE in accordance with the CMN Resolution N.2,689/00 may be subject to withholding tax at zero percent rate in case such investor, alone or along with related parties, (a) does not hold 40 percent or more of shares of the fund; (b) does not hold interests in the funds that grants such investor 40% or more of the fund's income; and (c) is not resident in a jurisdiction that taxes income at a maximum rate of less than 20%.

Notwithstanding the above, the acquisition of shares of investment funds in Brazil will generally be subject to the tax on transactions with bonds and securities (commonly known as IOF/Bonds) if the investment in such shares lasts less than 30 days. Investments that last longer than 30 days will not be taxed.





5. Final Remarks

The private equity and venture capital funds tend to improve corporate governance practices in the invested companies, which lead to better management decisions and increased profits. The funds also tend to choose companies that already care for good corporate governance, so that the transition into a shareholding structure involving a FIP or FMIEE may be smoother. Good corporate governance practices align shareholders and management towards decisions in the company's best interest, improve the quality of the available information, decrease cost of borrowing, reduce risks in general and minimize risks of fraud.

Corporate governance in Brazil has significantly improved in the last 15 years, as a result of many factors, including (a) changes in regulation improving minority shareholders' rights, (b) the creation of different listing segments by the São Paulo stock exchange, (c) the increased participation of FIP and FMIEE, and (d) the advocacy work performed by certain non-profit associations such as IBGC - Brazilian Institute of Corporate Governance, which published in 1999 the Code of Best Corporate Governance Practices (further revised in 2001, 2004 and again in 2009) and ABVCAP - Brazilian Private Equity and Venture Capital Association, which has published many studies about corporate governance, FIP and FMIEE, in special the Best Practices Code for Private Equity and Venture Capital Funds, published in 2011, created together with ANBIMA - Brazilian Financial and Capital Markets Association.

With regard to exit mechanisms of the funds, they are the means used to realize their gains after a period of investing in a given company, one of the essential requirements for the success of their activities. They include selling shares in a public offering, through stock exchange trading, or privately by selling to strategic investors. Initial Public Offerings (IPO), for instance, offer to funds an efficient exit mechanism.

Traditionally, the most widely disseminated exit strategy in Brazil was the private sale of ownership interests to strategic investors, usually larger companies within the same field of business or in an industry complementing that of the investee. The reason was that selling via public offering or stock trading would only comprise an efficient alternative for disinvestment if there were a favorable environment in which to do so, including a well-developed capital market culture.

In recent years, a combination of regulatory and economic factors drove the Brazilian capital market up to a new level of activity with a significantly enhanced number of IPO, thereby resulting in an expansion of exit alternatives for private equity funds. Consequently, the solidification of Brazil's capital market decisively helped to consolidate the selling of shares via public offerings or on the exchange as effective exit mechanisms for funds, in addition to the traditional method of private selling.

This guide was written by TOZZINIFREIRE ADVOGADOS.

Our private equity and venture capital practice leverages the experience of the firm's preeminent practices in mergers and acquisitions, capital markets, fund formation, bank lending, structured finance, tax and labor. We have a proven track record across a broad range of industry and service sectors where private equity players focus their investments when entering emerging markets.

R. Borges Lagoa, 1328
São Paulo, SP - Brazil 04038-904
T +55 11 5086-5000 | F +55 11 5086-5555
www.tozzinifreire.com.br





Founded in 2000, ABVCAP is a non-profit organization that represents the private equity and venture capital industry and promotes the development of long-term investments.

As a representative entity of the venture capital industry, ABVCAP's mission defends the interests of industry players together with public and private institutions, local and foreign, pursuing improve the public policies favorable to the promotion of these investments in Brazil.

Beside this, growing and enhancing several fronts of long-term investment in the country, in line with international practice, when applicable, highlights ABVCAP's mission, its strategic integration in capital market as disseminator and recycling of assets/companies on stock exchanges.

ABVCAP's activities aim to facilitate the relationship between global and local members of the long-term investment community, providing an environment that favors debate and fosters the strengthening of relationships.

The training programs, the development of studies and research on private equity and venture capital industry, the dissemination of reliable data, the promotion of good practices among the members of the community who represents and investee companies - especially those related to governance and responsible investment - as well as the interaction with similar or related entities, local and international, are part of our daily life, in favor of a healthy development of relationship between markets and spreading the culture of long-term investment.

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