Regulation of Private Equity Funds

(Article published in the October/November – 2003 edition of Latin Lawyer magazine)

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07.nov.2003

On July 16, 2003, the Brazilian securities and exchange commission ("Comissão de Valores Mobiliários" or simply "CVM") issued Instruction No. 391, regulating the constitution, operation and administration of private equity funds.

Based on this act, investors may now create funds to acquire not only "public" securities from companies listed in a securities exchange, but also "private equity" securities from privately owned or unquoted businesses.

The advantages brought by the instruction are twofold. On one side, it opens up new financing alternatives for companies that are yet too small or for other reasons not prepared to go to the stock market or another securities exchange. On the other side, investors will have a greater universe of assets from which to select when making medium and long-term investments, some with very high growth prospects. This is especially relevant considering that only a small percentage of Brazilian companies are listed in a securities exchange. The combination of these two aspects may prove to be very beneficial to the Brazilian economy.

It is true that investment through funds in private companies was possible before the enactment of Instruction No. 391. However, for that purpose investors and especially institutional investors such as pension funds – Brazil's largest investors – had to inadequately rely on rules applicable to stock funds in general or funds of investment in emerging companies. The Brazilian market lacked a set of rules specifically directed at private equity funds.

The funds regulated by Instruction No. 391 are aimed only at qualified investors. Therefore, they will only be available for financial institutions, pension funds, insurance companies, private investors with net funds exceeding R$ 5 million or holding investments in the securities market of R$ 250 thousand or more and other big players. Small and medium investors will not be able to invest in such funds.

In order to start operating, the fund will have to be previously registered with the CVM. Such registration will be automatically given upon the presentation of certain documents and information to the CVM (act of constitution of the fund, by-laws, prospectus, etc.).

A minimum investment amount of R$ 100 thousand (approximately US$ 36 thousand) will be required.

Private equity funds will be able to acquire shares, debentures, subscription bonus and other securities of any publicly traded or private company. The invested company may be a large, medium or even small enterprise.

The instruction establishes that the funds must have a participation in the decision making process of the invested companies. Accordingly, a fund may only have in its portfolio securities of companies in which it has some influence in the administration and definition of the business strategies, notably through the appointment of members of the Board of Directors. It is expected that this participation will give the fund the means of establishing an active, value-added and transformational investment strategy, as it is normally required of private equity investments.

Furthermore, the funds will only be able to participate in private companies that uphold certain standards of corporate governance. For instance, the financial statements of an invested private company must be submitted to an independent auditor, similarly to what is required of publicly traded companies. Any and all contracts and agreements with stockholders, officers and Board members, as well as shareholders agreements and similar documents, must be disclosed by the invested company to the fund.

Instruction No. 391 allows the creation of private equity funds to participate in businesses that are undergoing a reorganization or recovery process. In this case investors may pay up for quotas of the fund with assets or rights, including credits, linked to the reorganization or recovery process of the invested company. A group of creditors of a certain company that is facing financial difficulties may thus form a fund to look after their interests in such business.