2020

Private Equity Abroad: A Comparative Analysis of Brazil's Private Equity Framework and Europe's Private Equity Framework

Tyler L. Hinton

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I. Introduction

What is the risk? This question plays a huge roll in every investment decision. Investors often lose sleep thinking about the potential gains or losses associated with a transaction. Consequently, investment analysts have deviated from the colloquial meaning of risk, the exposure to danger, and view risk as any change, positive or negative, from zero.[1] In determining the risk of an investment, analysts most commonly use one of three formulas.[2] First, Coefficient of Variation, which is defined as:

$$\textit{Coefficient of Variation} = \frac{s}{\bar{x}}$$

Where:

s = Standard Deviation
$\bar{x}$ = Mean[3]

Investment analysts use the Coefficient of Variation to calculate the risk per unit of return.[4] Accordingly, when comparing the Coefficient of Variation of two investments the investment with the lower Coefficient of Variation is regarded as preferable because it presents less risk.[5]

The second formula investment analysts use when assessing risk is the Sharpe Ratio, which is defined as:

$$\textit{Sharpe Ratio} = \frac{Rx - Rf}{StdDev\ Rx}$$

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* Tyler L. Hinton is a JD candidate graduating from Seton Hall University School of Law in August of 2019. Tyler focuses his studies on global alternative investment regulations. In addition to his legal studies, Tyler is also pursuing his CFA designation. This Comment was supervised by Seton Hall University School of Law Professor Catherine M. McCauliff. Without Professor McCauliff's help and guidance this paper would not have been possible.

[1] CFA INSTITUTE, 2017 CFA LEVEL I: PORTFOLIO MGMT. 58 (2017).
[2] *Id.* at 45.
[3] *Id.* at 52.
[4] *Id.* at 63.
[5] *Id.* at 62.

Where:

Rx = Expected Portfolio Return
Rf = Risk Free Rate of Return
StdDev Rx = Portfolio Standard Deviation[6]

The Sharpe Ratio measures the risk return per unit of risk.[7] Accordingly, when comparing the Sharpe Ratio of two investments the investment with the higher Sharpe Ratio is more desirable because it indicates a greater return in relation to the level of additional risk taken to incur the return.[8]

The last common measure of risk used by investment analysts is the Roy's Safety First Ratio, which is defined as:

$$\textit{Roy's Safety First Ratio} = \frac{Rx - Rt}{StdDev\ Rx}$$

Where:

Rx = Expected Portfolio Return
Rt = Portfolio Target Return
StdDev Rx = Portfolio Standard Deviation[9]

Roy's Safety First Ratio calculates the probability that a portfolio or investment return will fall below a minimum threshold over a period of time.[10] As such, when investment analysts use the Roy's Safety First Ratio the portfolio or investment with the higher result is selected because it indicates a lower probability of a shortfall return.[11]

Each of the above formulas seeks to quantify the risk of an investment so investors can make important financial decisions with a greater degree of certainty.[12] The formulas use statistics to best predict the outcome of an investment.[13] This is a rational tactic as statistics and investing

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[6] *Id.* at 65.
[7] CFA INSTITUTE, *supra* note 1, at 78.
[8] *Id.* at 72.
[9] *Id.* at 82.
[10] *Id.* at 86.
[11] *Id.* at 88.
[12] *Id.* at 42.
[13] CFA INSTITUTE, *supra* note 1, at 86.

have always gone hand in hand. The intrinsic relationship between risk assessment and statistics presents an interesting challenge to legislators grappling with the question of how to protect investors and national markets while simultaneously creating a legal framework that is attractive to investors that are inherently risk adverse.

The financial crisis gave global regulators new momentum to attempt to regulate alternative investment funds.[14] This newfound energy and eagerness to regulate came from political institutions that villainized alternative investment vehicles.[15] Jurisdictions took many different approaches in regulating alternative investment vehicles. Accordingly, the legal framework surrounding alternative investment funds is complex and varies dramatically from jurisdiction to jurisdiction. Moreover, due to globalization, Alternative Investment Fund Managers (hereinafter AIFMs) worldwide seek to diversify the location of their investments with the goal of limiting beta risk and achieving returns in excess of the market.[16]

Behind the United States, Europe is the second leading location for leveraged buyout transactions.[17] Private equity funds that concentrate on emerging markets, however, are focusing

[14] Regulators use the term alternative investment fund to extend to the broad context of any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public." *See* Financial Stability Forum (FSF), Report of the Working Group on Highly Leveraged Institutions, 2000. However, the definition is dated. *See* Steve Johnson, *US hedge Funds move into 'Newcits'*, FIN. TIMES, Aug. 3, 2013, https://www.ft.com/content/ca1c625c-fb66-11e2-a641-00144feabdc0.

[15] For instance, Guilio Tremonti, the Italian Finance Minister described hedge funds as "hellish" and demanded their abolishment. *See* Tracy Corrigan, *Hedge Funds Don't Need Punishing - They are Suffering Enough*, THE TELEGRAPH, Oct. 16, 2008, http://www.telegraph.co.uk/finanee/comment/tracycorrigan/3212102/Hedgefunds-dont-need-punishing-they-are-suffering-enough.html.

[16] Returns above the market rate of return are common referred to as Alpha. *See generally* CFA INSTITUTE, *supra* note 1, at 86.

[17] Some have argued that Europe will lose a significant portion of its private equity business once the United Kingdom exits the EU. However, others have asserted a secondary argument that funds will move to Ireland and continue business as usual. *See* Michael Collins, *Brexit and Private Equity: Why Suspense is Worse Than Disappointment*, INVEST EUROPE (Mar. 23 2018), https://www.investeurope.eu/news-opinion/opinion/blog/2018/brexit-and-private-equity-why-suspense-is-worse-than-disappointment/.

less on developing economies in Europe[18] and looking more towards Brazil, Latin America's largest economy.[19] This shift is due to a unique set of regulations implemented by the Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários (hereinafter CVM)) that makes Brazil a prime target for any alternative investment fund seeking to operate in an emerging market.

This Comment seeks to accomplish two goals. First, it seeks to offer a comparative assessment of the legal framework governing private equity funds in Brazil and the European Union, as well as the regulations United States domiciled investors face when seeking to invest in the either of the above jurisdictions. As this comparative examination will reveal, private equity is subject to particularly stringent requirements in Europe, both on a transactional level and, subsequent to the adoption of the Alternative Investment Fund Managers Directive (hereinafter AIFMD), a fund manager level. It will also show that the European regulatory environment is starkly different from Brazil because Brazil, when enacting its regulatory framework, purposely took a contrasting approach to make it a desirable jurisdiction for private equity.[20] Second, this Comment will propose modifications to both Brazil and Europe's current legal frameworks to improve each jurisdiction's ability to facilitate foreign private equity investments.

II. History and Explanation of Private Equity

Kohlberg Kravis Roberts & Co. L.P. (hereinafter KKR) raised the first private equity fund to finance leveraged buyouts. Now, private equity firms are the new kings of capitalism.[21] Fueled

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[18] Many Eastern European Nations, such as Czech Republic, Greece, Hungary, Poland and Turkey, are characterized as emerging markets. *See, e.g.,* MSCI Emerging Markets Europe Index, *Sept. 2018 Report*, https://www.msci.com/documents/10199/1cf0a2d6-48fa-4c69-b397-b0faa3fc6e5c (last visited Oct. 17, 2018).

[19] The World Bank, *Latin Am. And Caribbean Econ. Data 2018: Brazil* (last visited Feb. 11, 2019), https://data.worldbank.org/country/brazil.

[20] *See infra* parts Part 144.

[21] *See* GEORGE P. BAKER & GEORGE D. SMITH, THE NEW FINANCIAL CAPITALIST: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE 59 (1998).

by an abundance of liquidity in the financial system, private equity reached its peak between 2003 and 2007.[22] This golden era ended when the housing bubble burst and the credit crisis emerged. These two factors caused the collapse of the private equity market as bidders tried to terminate or renegotiate their pending acquisitions.[23] Private equity struggled to recover through the early 2010s. This struggle was attributed to the sovereign debt crisis in Europe[24] as well as fragile debt markets. These factors, along with others, strained deal financing and evidenced the dependency of private equity activity on credit market conditions.[25] With some of the world's largest deals financed by private equity, however, it arguably has made a full recovery.[26]

Since the origins of the modern private equity industry in 1946, there have been four epochs marked by three boom and bust cycles. The early history of private equity, from 1946 through 1981, is characterized by relatively small volumes of private equity investment, rudimentary firm organizations, and limited awareness of, and familiarity with, the private equity industry.[27]

The first boom and bust cycle (from 1982 through 1993) is remembered by the dramatic surge in leveraged buyout activity financed by junk bonds. This period culminated with the massive buyout of RJR Nabisco before the near collapse of the leveraged buyout industry in the

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[22] The Economist, *The New Kings of Capitalism*, ECONOMIST, Nov. 25, 2004, http://www.economist.com/sites/default/files/special-reports-pdfs/3398415.pdf.

[23] Matthew D. Cain et al. *Broken Promises: The Role of Reputation in Private Equity Contracting and Strategic Default 2* (Sept. 11, 2012) (unpublished manuscript), *available at* http://papers.ssm.com/sol3/papers.cfm?abstract_id=1540000.

[24] While some nations in Europe have recovered from the sovereign debt crisis, Italy still faces major issues. In fact, Italy's new budget plan—which has been endorsed by its government—will widen its deficit to 2.4% of Gross Domestic Product ("GDP"). This proposed increase is in defiance of the EU rules. Giovanni Legorano, *Italy's Government Endorses Draft Budget That Would Widen Deficit: Coalition of Antiestablishment 5 Star Movement and the Far-Right League Backs Law in Defiance of EU Rules; Full Version Must Now Pass Parliament*, WALL ST. J. (Oct. 15, 2018), https://www.wsj.com/articles/italys-government-endorses-draft-budget-that-would-widen-deficit-1539636894.

[25] JOHN AUTHERS, EUROPE'S FINANCIAL CRISIS, 155 (2012).

[26] Paul J. Davis, *Private Equity: So Hot Even Second-Hand Funds Can Sell at a Premium*, WALL ST. J. (June 25, 2018), https://www.wsj.com/articles/private-equity-so-hot-even-second-hand-funds-can-sell-at-a-premium-1529924400.

[27] The Economist, *supra* note 22.

late 1980s and early 1990s.[28] The second boom and bust cycle (from 1992 through 2002) emerged from the ashes of the savings and loan crisis, insider trading scandals, the real estate market collapse and the recession of the early 1990s.[29] This period saw the emergence of more institutionalized private equity firms, ultimately culminating in the massive Dot-com bubble in 1999 and 2000.[30]

The third boom and bust cycle (from 2003 through 2007) came in the wake of the collapse of the Dot-com bubble, at this point in history leveraged buyouts (hereinafter LBOs) reached an unparalleled size and private equity was crowned the new kings of capitalism shortly after the Blackstone Group's 2007 initial public offering.[31] In the early years through to roughly the year 2000, the private equity and venture capital asset classes were primarily active in the United States. With the second private equity boom in the mid-1990s and liberalized regulations for institutional investors in Europe, however, a mature European private equity market emerged.

i. How Private Equity Works

Private equity is a generic term encompassing a wide variety of investments. The customary characteristic of private equity investments is illiquidity since private equity involves unregistered securities.[32] Private equity includes venture capital, development capital, mezzanine capital, LBOs, and distressed investing.[33]

Venture capital funds provide financing to start-ups and early-stage firms, thereby contributing to macroeconomic growth and job creation.[34] Development capital involves the

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[28] Sarah Bartlett, *History of the RJR Nabisco Takeover*, N.Y. TIMES, Dec. 2, 1988, at D15.
[29] The Economist, *supra* note 22.
[30] *Id.*
[31] *Id.*
[32] JACK S. LEVIN & DONALD E. ROCAP, STRUCTURING VENTURE CAPITAL PRIVATE EQUITY AND ENTREPRENEURIAL TRANSACTIONS 1-11 (2017).
[33] *Id.* at 1–10.
[34] *Id.* at 1–3.

provision of funds to existing companies to support their expansion.[35] Mezzanine funds provide financing to LBOs in the form of subordinated debt, with equity participation in the form of warrants to subscribe for shares in the borrower.[36] Distressed debt investors purchase debt of troubled companies at a discount, and then use their rights as debtholders to promote a restructuring of the company.[37]

Private equity investments are channeled through specialized intermediaries that are usually organized as limited partnerships, commonly known as private equity funds.[38] Private equity firms such as KKR, GS Capital Partners, the private equity arm of Goldman Sachs and Blackstone periodically establish private equity funds in the form of limited partnerships where they serve as general partners.[39] The general partner is responsible for managing the fund. Furthermore, the general partner solicits capital from investors, who become limited partners of these funds.[40] The principal investors in private equity funds are generally institutional investors such as pension funds, university endowments, insurance companies, and banks. Wealthy individuals, however, have also been known to invest in these funds.[41]

III. Private Equity Law in Europe

Since the 2008 financial crisis, private equity funds and hedge funds have been subject to an increase in global regulation,[42] even though no study has directly linked the 2008 financial crisis to such entities.[43] The United States of America became the first nation to pass major financial

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[35] *Id.* at 1–7.
[36] *Id.* at 1–5.
[37] *Id.* at 1–8.
[38] *See* GEORGE W. FENN ET AL., BD. OF GOVERNORS OF THE FED. RES. SYS., STAFF SERIES 168, THE ECON. OF THE PRIVATE EQUITY MARKET, 28 (1995).
[39] *See* Alan L. Kennard, *The Hedge Fund Versus the Mutual Fund*, 57 TAX LAW 133, 136 (2003).
[40] *See* Per Strömberg, *The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings* 4 (Sept. 2009) (unpublished manuscript), *available at* http://papers.ssm.com/sol3/papers.cfm?abstract_id=1429322.
[41] *See generally* Steven M. Davidoff, *Black Market Capital*, 2008 COLUM. BUS. L. REV. 172 (2008).
[42] Yogi Dewan, *There are Too Many Hedge Fund Billionaires*, FIN. TIMES, Oct. 31, 2015.
[43] The famous De Larosière Report dated February 25, 2009, deemed that alternative investment funds (hedge funds

market reform that targets private equity funds and other alternative investment vehicles.[44] Shortly thereafter, the European Commission passed Directive 2011/61/EU of the European Parliament and the Council on Alternative Investment Fund Managers and amending Directives, 2011 O.J. L 174/1 (hereinafter AIFMD). The goal of AIFMD was to regulate private equity funds, and other investment vehicles, throughout Europe in a uniform and comprehensive manner for the first time in the history of the European Union.[45]

Prior to Europe implementing the AIFMD, there was no direct European legislation regulating Alternative Investment Funds (hereinafter AIFs), including private equity funds. Instead, financial service providers were subject to numerous European State regulations that aimed to control various aspects of the financial service industry. Despite the post 2008 European Union directives trying to bring uniform regulations to financial markets, a political divide emerged between the European member states embracing a market-shaping paradigm and those embracing a market-making paradigm.[46] The countries adopting the market-making paradigm find value in competition, market efficiency and financial innovation.[47] Whereas the countries that favored the market-shaping paradigm favored investor protection, equal access to the markets, and financial stability.[48]

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and private equity funds) didn't play a major part in creating the crisis. However, they did play a part in worsening it by massive selling of shares and short-selling transactions of distressed entities. *See* JACQUES DE LAROSIÈRE, THE HIGH-LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU 24 (2009).

[44] On July 21, 2010, former President Barack Obama signed the Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111–203, H.R. 4173, commonly referred to as Dodd–Frank) into American Federal Law.

[45] Directive 2011/61 of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives, 2011 O.J. (L 174) 1 (EC) [hereinafter AIFMD]; *See* AUTHERS, *supra* note 25, at 155.

[46] Lucia Quaglia, *The 'Old' and 'New' Political Economy of Hedge Fund Regulation in the European Union*, 34:4 W. EUR. POL. 665, 666–82 (2011).

[47] *Id.* at 667–80.

[48] *Id.* at 666–79.

The United Kingdom and Ireland are the strongest advocates for the market-making paradigm, while the market-shaping paradigm received support from the Mediterranean countries and, in several instances, Germany.[49] In fact, even prior to the financial crisis, the long-standing goal of the advocates of the market-shaping paradigm was to regulate private funds.[50] Several member states instituted national regulatory regimes, which typically involved registration requirements and oversight of private equity fund managers, as well as structural separation of the fund manager and the custodian.[51] Nevertheless, these regulations were fairly rudimentary and did not address the complexity of private equity funds.

The financial crisis gave the EU new momentum in its attempt to regulate private equity funds. Regulators villainized private equity funds that took part in credit default swaps and demonized those fund managers who profited from the crash. But the crisis did not substantially alter the configuration of interests concerning private equity fund regulation in the EU.[52] Those concerns were present and known long before the financial crisis.[53] The newfound momentum to regulate private equity funds, however, did impinge upon existing regulatory paradigms because it was seen as implicitly validating the market-shaping approach exposed by the pro-regulation countries.[54] European Parliament produced several reports on the rationale for regulating private equity funds, and it hinted at the possibility of established parameters as the regulatory atmosphere was starting to focus on specific regulations aimed at alternative investment funds.[55]

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[49] *Id.* at 667–82.
[50] *Id.* at 670–82.
[51] DIRK ZETZSCHE ET AL., THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE 157 (2d ed. 2015).
[52] *Id.* at 155.
[53] Quaglia, *supra* note 46.
[54] *See supra* notes 49–52 and accompanying text.
[55] *See, e.g.*, European Parliament, *Report of the European Parliament with Recommendations to the Commission on Hedge Funds and Private Equity*, A6-0338/2008 (2008); European Parliament, *Report of the European Parliament with Recommendations to the Commission on Transparency of Institutional Investors*, A6-0296/2008 (2008).

The political motivations of Germany and France, backed by some members of the European Parliament, were the driving forces in the redesign of EU regulations on closed-ended funds[56]. France and Germany's actions were motivated by institutionally shaped economic interests,[57] as well as their market-shaping regulatory approach with regards to financial services. Further, the global financial crisis also influenced the new regulatory environment because it discredited the "British Model", which was the established regulatory model in the EU since the late 1990s.[58]

In adopting new financial regulations, the EU followed the redesigned regulatory process called 'Lamfalussy' approach.[59] The 'Lamfalussy' regulatory approach is a four-level approach to implementing new financial regulations. At level 1, the European Parliament and Council adopt the basic laws proposed by the Commission using the traditional co-decision procedure. This procedure is usually complex and time-consuming. Thus, the 'Lamfalussy' approach only uses level one for setting out framework principles.[60]

At level 2, the Commission can adopt, adapt, and update technical implementing measures with the help of consultative bodies composed mainly of EU countries representatives. The three European supervisory/consultant authorities that aid in the implementation of new financial standards are the European Banking Authority (hereinafter EBA), the European Securities and Markets Authority (hereinafter ESMA), and the European Insurance and Occupational Pensions

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[56] *See* ZETZSCHE, *supra* note 51, at 159.
[57] *See id.* at 159–60.
[58] *See id.* at 160–62.
[59] *See* The European Commission, *Regulatory Process in Financial Services: Lamfalussy Architecture*, (Feb. 10, 2019, 5:04 PM), https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-reforms-and-their-progress/regulatory-process-financial-services/regulatory-process-financial-services_it.
[60] *Id.*

Authority (hereinafter EIOPA). This allows the Council and Parliament to focus on key political decisions.[61]

At level 3, committees of national supervisors are responsible for advising the Commission in the adoption of level 1 and 2 acts and for issuing guidelines on the implementation of the rules. The applicable supervisory/consultant authority is charged with drafting both regulatory technical standards (hereinafter RTS), which are adopted by the Commission by a delegated act, and implementing technical standards (hereinafter ITS), which are adopted by an implementing act.[62] At level 4, the applicable supervisory/consultant authority is charged with ensuring the correct enforcement of EU rules by national governments.[63]

Under this process, the European Commission may adopt measures as binding technical standards that are implemented into law through by the member states.[64] The standards set forth by the European Commission act as the minimal requirements placed on the member states, and individual member states can modify language and impose greater regulations if they choose. Regardless, before the European Commission can issue a binding directive on the member states, the European Parliament and Council may raise objections to the delegated act and halt the legislative process.

On June 8, 2011, the European Parliament and Council used the Lamfalussy approach to pass the AIFMD.[65] ESMA is the European supervisory/consultant authority responsible for advising the Commission on the adoption of both regulatory technical standards and implementing

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[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] The European Commission is an institution of the European Union, responsible for proposing legislation, implementing decisions, upholding the EU treaties and managing the day-to-day business of the EU.
[65] *See Generally* AIFMD.

technical standards for the AIFMD.[66] When ESMA's advisory powers are applied to the AIFMD, ESMA has significant control over how the AIFMD is interpreted and applied to the member states. This latitude comes from the highly technical nature of the AIFMD and the broad and intentionally ambiguous language of the directive itself.[67]

The AIFMD is Europe's attempt to regulate the private equity industry and create a regulatory scheme that applies to all AIF managers conducting business in Europe. For example, it applies to EU AIF managers managing one or more EU AIFs, or non-EU AIFs. It also applies to non-EU AIF managers managing or marketing one or more EU AIFs. Further, the AIFMD applies to non-EU AIF managers marketing non-EU AIFs in the EU.[68] The only scenario where AIF managers fall outside the scope of the AIFMD is when no relationship with the EU exists, such as a non-EU AIF manager managing and/or marketing a non-EU AIF outside the EU.[69] The AIFMD regulates how an AIF is authorized, and it prescribes the operating conditions of the fund, including remuneration requirements, valuation, risk-management requirements, liquidity requirements, delegation rules, and depositary requirements. The AIFMD further places increased transparency requirements on AIFs, implements special provisions on leverage, and most importantly, controls how an AIF manager can market its fund within the EU and to its citizens.

The section below will examine the parts of the AIFMD that have the greatest impact on Private Equity investing in the EU. Each of the topics will be examined in detail. In particular, this section will focus on the AIFMD's marketing requirements, the AIFMD's anti-asset stripping provisions and a few additional restrictions found in the AIFMD.

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[66] See ZETZSCHE, *supra* note 51, at 165.

[67] ESMA is very similar to the SEC and FINRA, however it lacks an enforcement mechanism, its sole purpose is to promulgate rules.

[68] AIFMD, art. II § (1)(a)-(c).

[69] *See Generally* ASSOCIATION OF THE LUXEMBOURG FUND INDUSTRY, ANNUAL REPORT 2013-2014, 12–54 (June 19, 2014).

i. Marketing Requirements

First and foremost, investing in any fund that is subject to the AIFMD is only available to "qualified investors." Each member state makes the determination as to what criteria must be met by an investor to be considered a "qualified investor."[70] If a fund subject to the AIFMD markets its products or engages in business with an investor who is not deemed a qualified investor under the applicable law, the AIF and AIFM may be subject to civil penalties as determined by the jurisdiction in which the unqualified investor resides.

Article 67 of the AIFMD creates the EU wide marketing passport. Currently, the marketing passport is only available to AIFs that are created in the EU and managed by EU domiciled managers. Under Article 67, a European Union domiciled AIF manager must notify its home state regulatory agency of its desire to become a passport marketing fund. This is done by filing a notification that includes the following information: (a) The AIF rules; (b) The identification of the depository; (c) Information on the AIF which is available to investors, and when relevant; (d) Information on arrangements to prevent the AIF from being marketed to retail investors.[71]

Upon receipt of this information, the AIFs home state may either grant or deny the fund's registration. If the fund becomes registered, the AIFs' home state regulatory agency is required to send a notification to all other member states certifying that the fund is registered and allowed to actively market itself throughout the EU. This notification must be made within 20 days of the

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[70] *Compare* Loi n° 2003-706 du 1 août 2008 de sécurité financière [Law 2003-706 of Aug. 1, 2003 on the Financial Security] J.O. 177, Aug. 2, 2003, p. 760 (Fr) (stating to be a qualified investor in France one must have personal wealth of at least 500,000 Euro) *with* European Union (Alternative Investment Fund Managers) Regulations 2013 (SI 257/2013) (Ir.), http://www.irishstatutebook.ie/eli/2013/si/257/made/en/print (Article 42 states that an Irish professional investor is defined as an investor who demonstrates knowledge and expertise to make investment decisions, understands investment risks, and can meet the €100,000.00 subscription requirement). The terms professional investor, qualified investor and institutional investor are used interchangeably depending on the jurisdiction.

[71] *See* AIFMD, art. LXVII (hereinafter AIFMD art. 67).

AIFs' registration.[72] After the twenty-day period has lapsed, the AIF can market itself throughout Europe and need not register with any other state regulatory agency.[73]

Currently, the EU wide marketing passport is only available to EU AIFs with EU AIF managers. ESMA was required to issue an opinion as to whether the AIFMD marketing passport should be extended to non-EU AIFs and non-EU AIF managers,[74] but this opinion has been delayed due to the EU's negotiations with the United Kingdom regarding Brexit. [75] Based on earlier and conflicting ESMA advisory opinions, it is uncertain if the AIFMD marketing passport will be extended to non-EU AIFs.[76] Article 67 of the AIFMD imposes substantial restrictions on how a fund can market itself in the EU.

ii. Anti-Asset Stripping

The greatest impact of the AIFMD in the private equity sector has been through its asset stripping rules. The rules were designed to restrict the ability of Private Equity Funds to extract

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[72] *See id.*

[73] *See id.*

[74] *See id.*

[75] *See* BNP Paribas, *Alternative Investment Fund Managers Directive (AIFMD) - Regulation Memo*, Q2 Reg. Memo 2018 (Mar. 19, 2018), https://securities.bnpparibas.com/insights/aifmd-regulatory-memo-2018.html.

[76] While most experts think it is likely that ESMA will extend the EU-wide marketing passport to non-EU AIFs in 2018. *See* European Securities and Markets Authority, *European Parliament, the Council and the Commission on the Application of the AIFMD passport to non-EU AIFMs*, 2016 EMSA MEMO 1140 (Sept. 12, 2016) (indicating that it is likely passport marketing will be extended to non-EU AIFs but expressing minor hesitations); *See also* European Securities and Markets Authority, *ESMA advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs* (Jul. 18, 2016) (indicating that it is likely passport marketing will be extended to non-EU AIFs but expressing minor hesitations); European Securities and Markets Authority, *ESMA's advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs* (Jul. 30, 2015) (indicating that it is likely passport marketing will be extended to non-EU AIFs but expressing minor hesitations); European Securities and Markets Authority, *Letter from the European Commission to the European Securities and Markets Authority* (Dec. 17, 2015) (indicating that it is likely passport marketing will be extended to non-EU AIFs but expressing minor hesitations to certain countries including the United States and the Cayman Islands). Due to the power given to ESMA to make decisions regarding the AIFMD, it is still not certain if ESMA will extend the EU wide marketing passport to non-EU AIFs. Even though ESMA is required to issue an advisory opinion by 2018, ESMA can say that global regulations and market conditions are still not ripe enough to make this determination. Thereby pushing the possible extension of the EU-wide marketing passport to a later date.

funds in the first two years of ownership, following an AIF taking control of an unlisted company.[77] Specifically, the rules are (1) the portfolio company is not allowed to undertake any distribution (including dividends on shares), capital reduction, share redemption and/or acquisition of own shares, (2) the AIF cannot vote in favor of a distribution, capital reduction, share redemption and/or acquisition of own shares by the company, and (3) in any event, the AIF should use its best effort to prevent distributions, capital reductions, share redemptions and/or acquisition of own shares by the company.[78]

The rules apply to restrict distributions of pre-acquisition profits—in other words, to avoid reducing a company's value by asset stripping.[79] Where a fund is subject to the AIFMD asset stripping restrictions, it is imperative to confirm that any planned extractions of funds are permitted under the rules. The obvious circumstances in which this may apply are: (1) Up-streaming cash to service debt; (2) Repatriation of cash via regular dividend streams; and (3) Returning cash to investors in partial disposals via dividend recapitalizations.[80]

In restricting an AIF's ability to engage in asset stripping, the AIFMD limits the desire for distressed debt investors to participate in the European market.[81] One of the earliest functions of private equity funds is acquiring corporate debt and using the resulting security interests to ensure

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[77] Control means having over 50% of voting rights in a private company or 30% of voting in a listed company (a different figure may apply elsewhere in the EEA). *See* AIFMD art. XXVI (hereinafter AIFMD, art. 26).
[78] *See* AIFMD, art. XXX (hereinafter AIFMD, art. 30).
[79] A common practice in private equity is to acquire an undervalued company, and sell off the company's assets to generate a profit for the shareholders. This often occurs when a corporation's assets are worth more if they are sold separately. Inherent in the AIFMD's definition of asset stripping is a conflict as to who the new owners have a fiduciary duty to. It seems that the EU is saying the new controlling stakeholder has a duty to preserve a failing organization.
[80] *See generally* CFA Institute, *supra* note 1.
[81] *See* Peter Hill, *Private Equity Acquisitions - Asset Stripping Rules: It is almost a year since the Alternative Investment Fund Managers Directive (AIFMD) became fully effective in the UK*, RPC (June 5, 2015), https://www.rpc.co.uk/perspectives/corporate-insurance-and-financial-services/private-equity-acquisitions--asset-stripping-rules/.

corporate assets are being used efficiently to create value.[82] If the assets the AIF has a security interest in are creating losses and the corporation is delinquent in servicing its debt, the AIFM would either sell the assets by influencing the board of directors, or foreclose on the debt forcing the corporation to sell the assets to repay the AIF.[83] The anti-asset stripping provision was put into place by the European Commission due to a large number of takeovers that occurred in Eastern Europe with the sole purpose of selling the existing company for parts.[84] Often, such behavior resulted in layoffs. [85]

iii. Disclosure to Investors

AIFMs must disclose general information to investors regarding the: (1) financial and non-financial criteria of the remuneration policies; (2) practices for relevant categories of staff to enable investors to assess the incentives created; and (3) the requirements in relation to the type of information to be made available to investors will generally be information familiar to any investment fund managers.[86] The AIFMD, however, includes additional disclosure requirements such as: (1) Disclosure on insurance coverage for professional liability risks; (2) Details of any preferential treatment of investors, the type of investors who obtain such preferential treatment and their legal or economic links to the AIF or AIFM; (3) The percentage of AIF assets subject to special arrangements due to their illiquid nature and details of the special arrangements; and (4) Any changes to the maximum leverage that the AIFM may employ on behalf of the AIF, as well as any right of the reuse of collateral or any guarantee granted under the leveraging arrangement.[87]

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[82] LEVIN & ROCAP, *supra* note 32.
[83] *See generally* CFA Institute, *supra* note 1.
[84] *Cf.* Nauro F. Campos & Francesco Giovannoni, *The Determinants of Asset Stripping: Theory and Evidence from the Transition Economies*, 49 J. L. & ECON. 681, 681–82 (2006).
[85] *See id.* at 691–95.
[86] *See* ZETZSCHE, *supra* note 51, at 27–30.
[87] *See id.* at 27–30.

iv. Annual Report

The annual report to be provided to investors must comply with disclosure requirements, which will generally be familiar to fund managers. Nevertheless, AIFMs will also be required to include additional disclosures including: (1) Any material changes during the financial year; (2) The total amount of remuneration paid to AIFM staff for the financial year (fixed and variable) number of beneficiaries, and any carried interest; and (3) The aggregate remuneration (broken down by senior management and staff of the AIFM whose actions have a material impact on risk profile of the AIF).[88] While self-evident, an increase in reporting requirements directly correlates with the cost an AIFM must spend on compliance and directly impacts the profitability of the venture.

v. Reporting to Competent Authorities

AIFMs are also required to provide certain information on a regular basis to the supervisors of the member state in which each AIF is marketed.[89] The reporting must be in template format and include the following:[90] (1) The principal markets and instruments traded by it on behalf of the AIF; (2) The percentage of AIF assets subject to special arrangements arising from their illiquid nature, arrangements for managing liquidity, the risk management systems employed, the current risk profile of the fund, the main categories of assets invested in, and the results of stress tests performed in line with the AIFM Directive; (3) An annual report of the AIF and upon request, a list of all funds managed by the AIFM at the end each quarter; and (4) Where substantial leverage is employed, information on the overall level of leverage employed.[91]

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[88] *See id.* at 28–33.
[89] *See id.* at 45–50.
[90] Commission Regulation 231/2013 of Dec. 19, 2012, Supplementing Directive 2011/61/EU of the European Parliament and of the Council with Regard to Exemptions, General Operating Conditions, Depositaries, Leverage, Transparency and Supervision, Annex IV, J.O. (L 83) 1.
[91] *See* ZETZSCHE, *supra* note 51, at 45–50.

vi. Leverage

Leverage is defined in the Directive as: "any method by which the AIFM increases the exposure of an AIF it manages, whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means."[92]

The definition is potentially extremely broad. Clearly, straight cash borrowings of any type are included, but leverage will also include (1) convertible borrowings, (2) swaps, options and forwards, and (3) repurchasing agreement (repos) and reverse repos[93] and securities lending arrangements.[94] The definition itself does not differentiate between secured and unsecured borrowing or on the basis of duration, rates, terms or purpose.[95] It is quite possible that private fund structures may find themselves employing leverage, whether borrowing for investment, using hedging arrangements or perhaps bridging drawdowns.[96] The regulatory focus is on exposure.[97] The European Commission's Delegated Regulation (commonly known as the "Level 2 Regulation") expresses leverage as "the ratio between the exposure of an AIF and its net asset value."[98]

The Level 2 Regulation requires leverage to be calculated using two bases: (1) the gross method—the sum of the absolute values of all positions, so as to give an indication of overall

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[92] AIFMD, art. IV (hereinafter AIFMD, art. 4).
[93] A repurchasing agreement (repo) is a form of short-term borrowing for dealers in government securities. In the case of a repo, a dealer sells government securities to investors, usually on an overnight basis, and buys them back the following day. Whereas reverse repurchase agreement conducted by the central bank's Open Market Trading Desk (the Desk), also called a "reverse repo" or "RRP," is a transaction in which the Desk sells a security to an eligible counterparty with an agreement to repurchase that same security at a specified price at a specific time in the future. *See generally* LEVIN & ROCAP, *supra* note 32 *and* CFA Institute, *supra* note 1.
[94] AIFMD, art. 4.
[95] *Id.*
[96] *See* EUROPEAN SECURITIES AND MARKET AUTHORITY, FINAL REPORT: ESMA'S TECHNICAL ADVICE TO THE EUROPEAN COMMISSION ON POSSIBLE IMPLEMENTING MEASURES OF THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (2011).
[97] *See id.*
[98] Koen van der Veer et al., *Developing Macroprudential Policy for Alternative Investment Funds*, 202 ECB OCCASIONAL PAPER Series 1, 16 (2017).

exposure; and (2) the commitment method—the sum of the absolute values of all positions (with no setting permitted), adjusted for various factors, including the application of netting and hedging arrangements.[99] Note, though, that certain types of leverage can be excluded. There are two exclusions that may be particularly important for the private funds sector. The first exclusion is leverage in Portfolio Companies where an AIF's core investment policy is the acquisition of control over non-listed companies or issuers (i.e. most private equity). Under these circumstances the AIFM can exclude any leverage used in making such investments that would otherwise have an impact on the maximum leverage requirement prescribed by the AIFMD.[100] Additionally, when the above set of facts exists in an AIF, neither the AIF nor the AIFM has to bear potential losses beyond its investment in the relevant company.[101] The second exclusion is Drawdown Facilities where an AIFM can exclude temporary borrowing arrangements if they are fully covered by contractual capital commitments from investors in the AIF. Neither of these exclusions, however, are completely clear-cut.[102]

IV. Private Equity Law in Brazil, The FIP

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. From a legal standpoint, the intensification of private equity activity has prompted investors and governmental authorities to devise creative transactional structures and regulatory approaches that facilitate private equity ventures and manage the demands and challenges of an increasingly competitive market.

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[99] European Security and Market Authority, *Questions and Answers Application of the AIFMD*, 1873 ESMA 1, 23–26 (Dec. 15, 2015).
[100] EUROPEAN SECURITIES AND MARKET AUTHORITY, *supra* note 96.
[101] *Id.*
[102] Koen van der Veer et al., *supra* note 98.

The result of this interaction has been instrumental in reshaping the Brazilian Mergers and Acquisitions (M&A) landscape. These classic private equity transactions—formally implemented through direct acquisitions/investments or through local holdings incorporated as a limited liability company (sociedade limitada)[103] or corporation (sociedade por ações (S.A.))[104]—are now gradually making way for structures involving domestic investment funds as the vehicle to acquire or invest, hold, and manage portfolio companies until divestment is completed.[105]

The most popular private equity vehicle in the Brazilian M&A practice is the FIP, whose structure bears some similarity to the partnership fund model generally adopted in the U.S. and Europe. The Brazilian Securities and Exchange Commission, CVM, introduced FIPs in Brazil through Rule No. 391 (CVM Rule 391/03), issued on July 16, 2003.[106] 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.[107] More importantly, investments

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[103] The *sociedade limitada* is a type of Brazilian business organization that most closely mirrors limited liability companies, limited partnerships, and closely held companies under U.S. and U.K. laws. They are currently the most common company found in Brazil, 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 it is subject to under Brazilian law. For more information on *limitadas*, see Pinheiro Neto Advogados, *Doing Business in Brazil*, Vol. 1, Chapter 2 (2010).

[104] The *sociedade por ações* (*S.A.*) is a 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* Advogados, *supra* note 103.

[105] 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 because of regulatory constraints on portfolio composition).

[106] 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).

[107] After the creation of the FIPs fund structure, accompanied by Moody's updating Brazil's government debt rating to investment grade in September of 2009, *see* Public Debt Strategic Planning Department – Investors Relations, *Brazil Becomes Investment Grade by Moody's,* Brazilian Treasury (*Tesouro Nacional*) (2009), http://www3.tesouro.fazenda.gov.br/english/hp/downloads/Nota_Investment_Grade.pdf, Brazil experienced a dramatic increase in M&A activity largely funded by investment funds structured as FIPs. *Cf.* Eduardo Paoliello,

and exit strategies 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.[108]

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.[109] Additionally, investors can utilize FIPs for fundraising, financing, and implementing exit strategies, as applicable CVM regulations allow the placement of their units in the market.[110]

CVM Rule 391/03 is the core regulation applicable to FIPs. The self-contained and investor-friendly legal regime applicable to FIPs makes it the preferred and most flexible private equity vehicle in Brazil.[111] The adaptability of the FIP allows investors to contractually stipulate the most suitable set of governing and operational rules that will regulate the FIP and the legal interaction as owners of the vehicle.[112] These rules are customarily amalgamated in the FIP's charter, quota holders agreements, investment commitment agreements and a variety of service contracts that regulate matters bearing on the FIP's investment policy, decision-making procedures, capital commitments and calls, issuance and placement of units (quotas), distribution of proceeds, investment and divestment periods, minimum net equity requirements, management and performance fees, and liquidation.[113]

Private Equity 2017: Brazil, *in* INT'L. COMP. LEGAL GUIDE TO: PRIVATE EQUITY 2017 49 (Oliver Chang et al. eds. 2017).

[108] Kevin R. Horvath, *EMPEA Brief: The Shifting Landscape for Private Capital in Brazil*, EMPEA (May 31, 2018), https://www.empea.org/app/uploads/2018/05/EMPEA-Briefs_Brazil_FINAL_WEB.pdf.

[109] Paoliello, *supra* note 107, at 55–57.

[110] Horvath, *supra* note 108.

[111] *See, e.g.,* João Busin & Jerry de Abreu, *The Brazilian FIP: Recent Clarification: What is a Private Equity Entity? What are the Tax Consequences of Not Being a FIP?*, 25 EMPEA LEGAL AND REG. BULL. 10–11 (2018); Paoliello, *supra* note 107 at 56–57.

[112] *See* CVM Rule 391/03

[113] This list is not exhaustive but limited to the most common activities regulated by the service contract.

i. Form and Ownership Structure

In essence, the FIP is a collective investment vehicle formed as a *condominium*, allowing co-ownership of assets to be exercised among investors.[114] FIPs can only operate in Brazil upon registration with the CVM.[115] Additionally, the FIPs, along with their securities (quotas) and investors (quota holders), are subject to the CVM's oversight.[116] The FIP must be organized as a closed-end *condominium* consisting of an un-personified pool of assets managed and represented by an administrator registered with the CVM.[117]

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.[118] 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.[119] Additionally,

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[114] 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.

[115] CVM Regulation No. 325/00 requires all FIPs to register and submit its charter to the CVM. *See* Flesch & Prado, *supra* note 105, at 89–90; BUREAU OF ECON., ENERGY, AND BUS. AFFAIRS, U.S. DEP'T. OF STATE, 2011 INVESTMENT CLIMATE STATEMENT – BRAZIL (March 2011).

[116] *See generally* CVM Rule 391/03.

[117] A close-ended fund (*condominium*, if the fund is located in Brazil) is an investment vehicle, 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 quota holders throughout the term of the fund and pursuant to its organizational documents. *See* ELROY DIMSON & CAROLINA MINO-PALUELLO, THE CLOSED-END FUND DISCOUNT 1-2 (Bette A. Collins et al. eds. 2002).

[118] *See generally* Fernando J Prado Ferreira & José Paulo Pimentel Duarte, *Brazil*, *in* THE ASSET MANAGEMENT REVIEW 90 (Paul Dickson et al. eds., LAW & BUS. RES. LTD., 5th ed. 2016).

[119] *See supra* Part 114 and note 114 and accompanying text (so long as providing the aforementioned services is not prohibited by the terms of the service contract, there is no CVM rule or other regulation prohibiting a FIPs from engaging in said activity).

Brazilian civil and tax law requires the FIP to obtain a federal taxpayer number and to book any transactions it undertakes in its own name and on its own behalf.[120]

ii. Ownership Rights and Quotas

Equity units known as "quotas" represent the ownership interest rights of the FIP's investors, or quota holders.[121] Each quota in a FIP corresponds to a ratable share of the portfolio assets held under joint ownership by the quota holders.[122] Thus, the value of each quota is calculated by dividing the net equity of the FIP by the number of outstanding quotas. Each quota carries one vote at the quota holders' general meeting, unless the FIPs organizational documents admit classes of quotas with different voting rights.[123]

iii. Permitted Investments

The FIP's investments are primarily comprised of 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.[124] The remaining portion of the FIP's portfolio may consist of liquid fixed-income instruments and other financial assets, mainly for cash management purposes.[125] The FIP's charter must establish the eligibility criteria that apply to publicly held companies that the FIP invests in.[126]

Publicly and closely held corporations are also subject to the minimum set of corporate governance standards imposed by CVM Rule 391/03. Closely held companies that the FIP invests

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[120] FIPs are also required to register with the National Register of Legal Entities (Cadastro Nacional da Pessoa Jurídica (CNPJ)). See Flesch & Prado, supra note 115, at 81–84.
[121] See, e.g., Busin & Abreu, supra note 111, at 10–11; Kevin R. Horvath, supra note 108; Eduardo Paoliello, supra note 117, at 55–57.
[122] See, e.g., Busin & Abreu, supra note 111, at 10–12; Eduardo Paoliello, supra note 117, at 55–58.
[123] See Ferreira & Duarte, supra note 118, at 90–93.
[124] See Flesch & Prado, supra note 115, at 81, 84–86.
[125] See id. at 81.
[126] See CVM Regulation No. 325/00; Flesch & Prado, supra note 115, at 81, 89–90.

in must comply with certain minimum governance guidelines such as: (1) The establishment of a unified one-year term of office for the entire board of directors (no staggered boards); (2) Annual audit of their financial statements; (3) Disclosure of related-party agreements, shareholders' agreements, stock option plans, and share buyback plans; and (4) The obligation to adhere to certain differentiated levels of corporate governance practices in case the company goes public.[127]

If a FIP chooses to invest in either a closely held or publicly held company, the investment is not subject to net worth requirements or minimum review.[128] Moreover, no mandatory diversification requirements or concentration requirements apply to the allocation of the FIP's portfolio, unless the FIPs charter states otherwise.[129] Additionally, the FIP can place its entire net equity in a single investment or it may distribute its investments over as many targets as it desires, so long as the charter is not violated.[130] Lastly, there are no restrictions on the number of FIPs that can invest in a single entity.[131]

iv. Investment Restrictions

The modalities of investment funding are: (1) The traditional funding[132]; (2) Mezzanine;[133] and (3) Private investment in public equity ("PIPE").[134] It is the nature of this instrument to reinvest capital in new businesses without any distribution of income to shareholders. The purpose is to raise the market value of the asset for a possible sale, either in the promotion of new business or in the recovery of illiquid assets. Its characteristic is illiquidity.[135] The CVM rule limits FIP's

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[127] *See* CVM Rule 391/03.
[128] José Carlos Junqueira Sampaio Meirelles & Caio Carlos Cruz Ferreira Silva, *Brazilian Private Equity Funds (FIPS): A DNA Change in Brazilian M&A Deals*, 4 HARV. BUS. L. REV. 15, 22 (2013).
[129] *Id.*
[130] *Id.*
[131] *Id.* at 22–23.
[132] Done in the form of capital. JACK S. LEVIN & DONALD E. ROCAP, *supra* note 32, at 1–10.
[133] Subordinated debt investments, hybrid financing instruments, including debentures convertible into shares or other forms and subscription rights. *Id.*
[134] *Id.*
[135] *Id.*

investments in liquid assets to 10% of net equity.[136] The remaining 90% must be invested in (1) shares, (2) subscription warrants, (3) simple debentures, (4) other securities convertible or exchangeable into shares issued by publicly or privately held companies, or (5) titles and securities representing participation in limited liability companies.[137]

Additionally, The FIP cannot invest in derivatives, except for hedging purposes.[138] Furthermore, only the invested companies that make up the FIP's portfolio may hold direct ownership in real estate assets, not the FIP itself.[139] As a result, when FIPs are used as the vehicle to invest in real estate, "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."[140]

The CVM placed some limits on FIPs. One major limit is that FIPs are not allowed to invest in any foreign venture.[141] Additionally, the CVM restricts FIPs from soliciting or contracting loans (except under very specific limited circumstances) and providing guarantees.[142] Regardless, "holding companies or SPCs that the FIP invests in can be used as vehicles in leveraged acquisitions of, or investments in, target companies."[143]

v. Eligible Investors

Nearly all jurisdictions worldwide recognize that risks associated with private equity investments are much greater than investments in public markets.[144] Accordingly, nearly every

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[136] *See* CVM Rule 391/01
[137] *See id.*
[138] *See* CVM Rule 391/03.
[139] *See id.*
[140] Meirelles & Silva, *supra* note 128, at 25.
[141] *See* CVM Rule 391/03.
[142] *See id.* (except when approved by a qualified majority of 2/3 or more of the quota holders in a general meeting and as expressly permitted by the fund's bylaws).
[143] Meirelles & Silva, *supra* note 128.
[144] *See generally* ELROY DIMSON & CAROLINA MINO-PALUELLO, *supra* note 117.

jurisdiction limits private equity investing to qualified investors only[145] because the risks associated with such investments make them unsuitable for the general public.[146] 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.[147] CVM Rule 391/03 recognizes the risks inherent in private equity investing and limits investment into FIPs to those who are financially capable and possess the financial sophistication sufficient to make informed decisions.

CVM Rule 391/03 sets the FIPs minimum capital commitment per quota holder at 100,000 Brazilian Reals. Hence, only "qualified investors" as defined by the CVM, can acquire the quotas of a FIP. This target investor restriction gives investors great latitude in structuring FIPs and regulating their operation in accordance with the rules suited for each deal or set of deals. Moreover, non-resident investors must make the required investment in accordance with the rules

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[145] While every jurisdiction has its own definition as to what a qualified (or institutional) investor is, it is widely understood that these investors are individuals with high net worth. *See, e.g.*, LEVIN & ROCAP, *supra* note 32, at 1–3; DIMSON & MINO-PALUELLO, *supra* note 117; Steven M. Davidoff, *supra* note 41.

[146] In 2001 the definition of "security" changed under Brazilian Law when Law No. 10,303/01 amended 6,385/76 established a narrow definition of "security", which only applied to publicly traded entities. Thus, under the new definition and meaning of the term "securities" an investor's stake in a private equity fund falls outside the scope because they are: (1) privately held organizations and (2) investment in a private equity fund is limited to qualified investors. *See* Marcelo Trindade, CVM, *Strategic Challenges for the Investment Fund Industry* 11 (March 5, 2012), http://www.cvm.gov.br/port/public/publ/seminario/PAINEL01/Marcelo%20Trindade%20-%2 0%20ingles.pdf.

[147] Even though the aforementioned risks are specific to FIPs, the specific risk to FIPs is nearly the same when the risk is explored globally. *See, e.g.*, LEVIN & ROCAP, *supra* note 32, at 1–3; DIMSON & MINO-PALUELLO, *supra* note 117; Steven M. Davidoff, *supra* note 41.

of Resolution No. 2,689, issued by the National Monetary Council (CMN) on January 26, 2000, which apply in addition to the prerequisites of CVM Rule 391/03.[148]

vi. 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. 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 is unique to FIPs and is especially attractive to private equity investors.[149]

Under CVM Rule 391/01, the FIP must retain some degree of effective influence in the invested companies' strategic decisions, regardless of how the FIP invests in the target company. 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 shareholder agreements granting it discretionary powers over the invested company; or (c) Enter into other agreements or arrangements that ensure the FIP's actual influence over strategic policy and management of the invested company.[150]

vii. 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 a FIP are not performed by a general partner. Instead they are performed by an independent legal entity accredited with the CVM to engage in securities portfolio administration activities.[151] The

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[148] CMN Resolution 2,689/00 allows non-resident private equity investors to remit funds into Brazil to subscribe for and pay in FIPs' quotas and repatriate their capital abroad.

[149] *See generally* Ferreira & Duarte, *supra* note 118.

[150] Agreements or arrangements of this sort can entail, for example, veto rights and supermajority quorums. *Cf.* CVM Rule 391/01.

[151] These entities are known as *administrador*. *See* Ferreira & Duarte, *supra* note 118.

administrator is responsible for the legal representation of the FIP as well as for managing the FIP's routine activities, which include paying fees, receiving dividends and interest, preparing financial statements and reports, signing shareholder agreements of companies in which the FIP is a shareholder, providing reports and information to investors, and other activities established in the FIP's charter or determined by the quota holders' general meeting.[152]

The quota holders who attend the general meeting are the key decision-makers in a 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.[153] 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.[154] 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.[155] 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.[156]

viii. Taxation of FIP and its Quota holders (PRE Jan. 1, 2018)

Prior to January 1, 2018, FIPs were generally exempt from income tax generated from gains in their financial investments due to the FIP's classification as a *condominium* under Brazilian law.[157] Contrarily, Brazilian tax law did not treat the target companies the FIP invested

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[152] *See id.* at 90–95.
[153] Meirelles & Silva, *supra* note 128, at 22–23.
[154] CVM Rule 391/01.
[155] *See id.*
[156] Meirelles & Silva, *supra* note 128, at 22–24.
[157] *Id.* at 28–29; *See also* 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-benefitsof-brazilian-fips/ [hereinafter LAVCA].

in as tax-transparent, but rather taxed them as independent entities.[158] "The fact that the FIP [was] *per se* exempt from taxation on acquisitions and divestitures [made] it a very attractive vehicle for private equity investment."[159] Moreover, the exempt treatment was extended to non-Brazilian quota holders, which provided an extra incentive for foreign investors to use FIPs as investment vehicles when investing in Brazil.[160]

In addition, dividends received by the FIP and forwarded directly to the quota holders were not subject to the Brazilian withholding income tax ("WHT").[161] Nonetheless, interest on net equity received by the FIP and repaid to quota holders as well as other payments made to FIP's quota holders domiciled in Brazil were subject to WHT at the rate of fifteen percent.[162] Nevertheless, "WHT assessed on the income earned by non-resident investors arising from an interest in a FIP as well as upon repatriation of the capital originally invested in the FIP are currently subject to a zero percent rate, provided that certain conditions are met."[163] The above tax treatment given to the FIP prior to January 1, 2018, helps explain, "why foreign private equity feeder funds and other non-resident investors usually treat FIPs as the preferred vehicles for private equity investments in Brazil."[164] Naturally, "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."[165]

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[158] Meirelles & Silva, *supra* note 128, at 27–28; *see also* LAVCA, *supra* note 157.
[159] Meirelles & Silva, *supra* note 128 at 28.
[160] *Id.* at 28; *See also* LAVCA, *supra* note 157.
[161] Ricardo C. Veirano & Gustavo Moraes Stolagli, *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).
[162] *Id.*
[163] Meirelles & Silva, *supra* note 128, at 28.
[164] *Id.* at 28–29.
[165] *Id.* at 28.

ix. Tax Post 2018[166]

The tax benefits found in the FIP changed on January 1, 2018, with the passage of Provisional Measure No. 806/2017 (hereinafter "MP 806"), which established new rules regarding the taxation of FIPs. Under MP 806, investors in FIPs qualified as investment entities are now taxed via Withholding Income Tax (IRRF) on the sale of assets of the fund, at a rate of 15%.[167] The taxation is based on the grounds of a fictitious distribution of income.[168] FIPs not qualified as an investment entity (Equity FIPs), are now taxed as legal entities and any earnings and income not distributed by January 2, 2018, will undergo the same fictitious distribution and be taxed at a 15% rate.[169]

V. Brazil Offers a More Competitive Landscape for Private Equity Because it Regulated in a Manner That Supports Economic Growth by Creating Incentives for Private Investment

When the legal frameworks are compared some similarities become immediately apparent. Consequently, the similarities in the regulations are addressed first, as well as why the similarities appear. A subsequent section will discuss some of the major differences between the two legal frameworks and will reach a conclusion as to why the differences exist. The last section will focus solely on the legal frameworks from an investor's perspective[170] and conclude that Brazil offers a more favorable regime for Private Equity investing compared to the European Union.

i. The Similarities Between Jurisdictions

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[166] There are potential Constitutional challenges to the new tax scheme for the FIP but those challenges will not be addressed in this Comment.
[167] *See* Provisional Measure No. 806/2017.
[168] *See* Luiz Girotto and Tayron Karlos, *Provisional Measure No. 806/2017 and the Impacts on Investment Funds*, GRIROTTO LEGAL MENTORING (Feb. 1, 2018), http://www.girottoadv.com.br/en/provisional-measure-no-8062017-and-the-impacts-on-investment-funds/.
[169] *See id.*
[170] This analysis will assume the investor is weighing two identical investments with the same risk and return potential and is looking solely at the legal framework to determine where to invest.

After examining the above legal frameworks, certain similarities exist between Europe's private equity scheme and Brazil's private equity scheme. These likenesses share an analogous purpose and provide similar protections to the citizens of the respective jurisdictions. This section will first look at the legislative reason behind limiting alternative investing to qualified investors and restricting access to such investment vehicles. Second, this section will look at the similarities in the reporting requirements for private equity funds and why these requirements exist. Lastly, the similarities between the European Union and Brazil's requirements for structuring and governing a fund are examined.

Like most jurisdictions around the world, Brazil and the European Union restrict access to alternative investment vehicles and only allow qualified investors to invest.[171] While every jurisdiction has a different definition of what defines a qualified investor,[172] most all governments forbid the general public from using alternative investment vehicles. This is because alternative investment vehicles, such as private equity and hedge funds, carry a much greater risk for the investor. Private equity funds derive their risk from their closed-ended structure.[173] Close-ended funds require investors to commit capital to a fund. This is referred to in the industry as committed capital. Committed capital may be put towards a so-called blind pool where the investor does not know specifically how or where the money is to be invested. Such an arrangement offers fund managers leeway to make investments as they deem appropriate to generate high internal rates of return for the investors.[174]

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[171] *See supra* notes 25, 48, 126–128 and accompanying text; *See also* 17 C.F.R. § 230.501(a) (defining an accredited investor in the United States as "Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000 . . . . [or] any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.").
[172] *Compare supra* Part 70 and note 70 and accompanying text *with* Part 144 and notes 144–148 and accompanying text.
[173] LEVIN & ROCAP, *supra* note 32, at 1–5.
[174] *Id.*

When a fund pursues investments, such as an offering to acquire a business, the amount of committed capital may be seen by the business owner as a way to gauge the ability of the fund to follow through with the offer. As committed funds are called upon to make investments, the contributing investors will be granted a portion of the overall returns the investment brings to the fund.[175] While committed capital does not indicate immediate liquidity, it can demonstrate a fund's capacity to pursue and fulfill deals.

Put simply, the main reason governments limit the general public's access to alternative investment vehicles is to protect individuals that they deems cannot bear the risk of making such an investment.[176] The global regulations restricting access to such investment vehicles and unregistered security to the "Smart Money"[177] is done by excluding the general public from the marketplace based on arbitrary standards. "[T]hese smart-money approaches promote the dual goals of capital formation and investor protection."[178] Currently, this approach is being used around the world to protect citizens from taking financial risks they may not be able to bear if the endeavor fails. It has been argued, however, that restricting the general populations' access to investment vehicles that generate the highest returns adds to the increasing financial inequality in society today.[179] Nonetheless, no jurisdiction has taken any action to expand alternative investment vehicles to everyone.[180]

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[175] *Id.*
[176] *See, e.g.*, LEVIN & ROCAP, *supra* note 32, at 1–5; ZETZSCHE, *supra* note 51, at 1–21; Abraham J.B. Cable, *Mad Money: Rethinking Private Placements*, 71 WASH. & LEE L. REV. 2253 (2014).
[177] "Smart Money" means those who qualify as a professional investor. Cable, *supra* note 176, at 2253.
[178] *Id.*
[179] Thaya Brook Knight, *Your Money Is No Good Here: How Restrictions on Private Security Offerings Harm Investors*, 833 CATO POL'Y ANALYSIS 1, 9–17 (2018).
[180] *Compare supra* Part 70 and note 70 and accompanying text *with* Part 144 and notes 144–148 and accompanying text.

Another similarity in the two legal frameworks is the basic reporting and disclosure requirements. It is important to note that the specifics of the reporting requirements make the jurisdictions vastly different and will be addressed in the following section.[181]

Both Brazil and the European Union require private equity funds to disclose certain material information to investors.[182] The primary purpose of the disclosure is to make sure the fund's investors have knowledge of any material changes taken by the fund manager or to ensure the investors know of any material changes to the fund itself. Additionally, both jurisdictions require funds to report certain information to the appropriate regulatory authorities.[183] This is done to certify that funds are not engaging in illegal activity.

Like the "smart money" requirements, the basic reporting and disclosure requirements are standard and something every fund manager around the world must understand and adhere to.

ii. Differences Between Jurisdiction.

While the basic regulatory framework is similar, the laws could not be more different. First, when Brazil was enacting the FIPs investment structure, it did so with the intent to facilitate foreign private investment.[184] Contrarily, the AIFMD aims to restrict foreign investment in Europe.[185] While these intentions are clear from the effects of the law, it must be noted that within Europe there are competing thoughts on what market theory is best between nations.[186] The European Union is an intergovernmental organization therefore it must act in accordance with the majorities wishes. This is a much greater challenge than governing a single

[181] *See infra* Part 144.
[182] *Compare supra* Part 70 *with* Part 144.
[183] *Compare supra* Part 70 *with* Part 144.
[184] *C.f. supra* Part 144.
[185] *C.f. supra* Part 49.
[186] *See supra* Part 49 and notes 49–52 and accompanying text.

state like Brazil because different government must come to an agreement before any change may take place.

Another major difference between the regulations is that Brazil's FIP program limits the type of investments available to foreign private equity investors seeking to do business in Brazil.[187] In doing so, Brazil sought to insulate itself from many risks presented by the presence of foreign capital.[188] While investors have bypassed some of the restrictions by using subsidiaries and holding companies, such roadblocks do deter some of the potential capital.[189] Europe's AIFMD contrarily does not restrict the type of investments that investors can make, but rather subjects foreign investors to the heightened regulations all European fund managers must abide by.[190]

Additionally, another major difference is the extraterritorial nature of the AIFMD. Like many recent European Directives, the AIFMD has an extra territorial effect beyond the European Union. The AIFMD gives protection to all European domiciled investors, and requires compliance from all European fund managers operating outside of the European Union.[191] The extraterritorial aspect presented in the AIFMD is becoming more common among European Union regulations and is most present in the AIFMD's marketing requirements.[192] As explained above, these rules limit the ability of a fund to market itself to new investors in Europe or to investors with European citizenship. Such extraterritorial reach is not present in the Brazilian regulation.[193] This is likely due to the size of the market place and the government's goal of

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[187] *See supra* Part 144.
[188] *C.f. supra* Part 144.
[189] *C.f. supra* Part 144.
[190] *C.f. supra* Part 49.
[191] *C.f. supra* Part 49.
[192] *See, e.g.*, Commission Regulation 2016/679, 2016 O.J. (LI 19), Directive 2014/65/EU (MiFID II) and AIFMD.
[193] *C.f. supra* Part 144.

increasing certain types of private investment in Brazil.[194] Additionally, Brazil does not impose any restrictions on fund marketing, other than the requirement that the fund only takes investments from qualified investors.[195]

The final major difference between the regulations is that Brazil grants favorable tax treatment to FIP investments. Prior to 2018, capital gains derived from FIPs investments were taxed at 0%.[196] This generated greater return for investors and allowed the investment to reach alpha in a shorter time frame.[197] This favorable tax treatment incentivized investors and lowered the risk of FIPs investments in Brazil because the investment did not need to generate as much money to create an acceptable return.[198] This statement remains true even after the tax law changed in 2018. While the investments are less favorable compared to an identical investment at a 0% capital gain tax rate, the new rate (15%) are still reasonable when compared to other global tax rates.[199] The European Union, unlike Brazil, does not provide any special tax rates for private equity investment. This is likely because to change any tax regulation, the European Union must do so by a unanimous vote.[200] Accordingly, it is highly unlikely that the European Union would ever make any change related to the tax treatment of investment income.

As illustrated above, Brazil's FIPs offers investors a more favorable legal landscape. The law creates a favorable tax rate for the investments and it does not restrict the funds' ability to market itself and find new investors. Even though the law restricts the types of investment that qualify for FIPs, there are means to get around these restrictions. Thus, the restrictions become

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[194] *C.f. supra* Part IV.
[195] *C.f. supra* Part IV.
[196] *C.f. supra* Part IV(viii).
[197] *C.f. supra* Part IV(viii).
[198] CFA INSTITUTE, *supra* note 1, at 86.
[199] *See supra* Part IV (ix); *see also* DLA PIPER, GUIDE TO GOING GLOBAL: TAX (2019).
[200] Treaty on the Functioning of the European Union, Art. 326-334, 2012 O.J. C326/47.

a slight deterrence, not an all-out bar. Brazil could make FIPs more appealing to foreign investors if it allowed FIPs to invest in real estate development and/or it repealed the 2018 tax changes.

If the European Union wants to become a more investor friendly jurisdiction, it should consider changing the fund marking requirements and making Passport Marketing available to all. It should also consider reevaluating its standards on the use of leverage. In almost all jurisdictions, funds can use more leverage than what is allowed under the AIFMD. Allowing funds to leverage themselves helps increase the flow of capital into certain investments and generates greater returns. Considering investing in any alternative investment vehicle is restricted to qualified investors, making such a change would be consistent with the existing provisions. Lastly, there is no evidence that the 2008 financial crisis was caused by alternative investment funds and their use of leverage. Thus, the imposition of such a drastic restriction seems illogical.

VI. Conclusion

In conclusion, Brazil, by legislating in a manner that sought to promote private investment has created a much more investor friendly jurisdiction when compared to the European Union. Additionally, while both jurisdictions could enact changes that would facilitate private investing without impacting the investor protection created under the respective regulatory frame works, Brazil is in the best position to do so because it already possesses a market making mentality, unlike Europe where market shaping has a stronghold.