

# LEGAL STRUCTURE OF PRIVATE EQUITY AND VENTURE CAPITAL FUNDS IN BRAZIL

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Brazilian Private Equity &  
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Brazilian Private Equity and Venture Capital Association

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# LETTER FROM THE PRESIDENT

In August 2016, the Brazilian Securities Commission (CVM) issued two important Instructions regulating Brazilian Private Equity Investment Funds (*Fundos de Investimento em Participações* – FIPs), replacing CVM Instructions N° 209/94 and N° 391/03.

Promulgated after ample consultations with the public, CVM Instructions N° 578 and N° 579 were preceded by a working group that consisted of market institutions, whose representatives discussed points that were crucial for the development of the Private Equity and Venture Capital (PE&VC) segment in alignment with international parameters, together with the progress of these funds since the first directives were issued almost two decades ago. Through its Regulation Committee, the Brazilian Private Equity & Venture Capital Association (ABVCAP) and its members played active roles in this process of updating Private Equity Investment Fund rules in Brazil, highlighting stumbling-blocks and suggesting effective and necessary adjustments required to adapt the rules to the current development stage of Brazil's PE&VC segment, based on international benchmarks.

If on the one hand CVM Instruction N° 578 ushers in a more modern approach to operations, consolidating and creating different Private Equity Investment Fund categories, allowing investment in limited liability companies, and introducing mechanisms designed to fine-tune governance in investee companies, on the other, CVM Instruction N° 579 – which regulates the preparation and disclosure of financial statements by Private Equity Investment Funds – introduces the concept of fair value for companies in fund portfolios.

It is also important to stress that CVM Instruction N° 558/2015, introduced significant alterations to the regulations for securities administrators and managers, effective from January 2016 onwards. Noteworthy among

them is the requirement to set up internal controls, together with new compliance and risk management mechanisms for security portfolio administrators.

Assisted by the TozziniFreire Advogados law firm, ABVCAP is issuing a new version of the handbook outlining the legal structure of private equity and venture capital funds (*Estrutura Legal dos Fundos de Private Equity e Venture Capital*), which explains the alterations introduced by these new regulations for Brazilian Private Equity Investment Funds.

Through this publication, ABVCAP offers yet another knowledge-enhancing tool, not only for investors, administrators and managers, but also for academics and researchers eager to explore this market in greater depth. Available in Portuguese and English, this handbook is yet another step forward in the process of fine-tuning responsible investment practices for these funds, following in the footsteps of the 2011 Regulation and Best Practices Code for Equity and Emerging Enterprise Investment Funds (FIP/FMIEE) issued jointly by the Brazilian Private Equity & Venture Capital Association and the Brazilian Financial and Capital Markets Association (ABVCAP/ANBIMA), as well as the Venture Capital and Private Equity Guidebook (published in 2013 and updated in 2015) drawn up by the Institutional Investors Executive Committee at ABVCAP, both currently under review in order to adapt them to these new CVM rules, with new editions planned for the near future.

We offer our warmest thanks to the Private Equity group at the TozziniFreire Advogados law firm for this important contribution.

**Fernando Cezar Dantas Borges**  
President

# PRIVATE EQUITY FUNDS AND VENTURE CAPITAL FUNDS IN BRAZIL

## 1. BRAZILIAN INVESTMENT FUNDS OVERVIEW

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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 legal entities that comply with Rule 558, enacted by the Brazilian Securities Commission ("CVM") dated as of March 26, 2015, as amended ("CVM Rule 558/15"), 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 are a legal entity, also have to comply with CVM Rule 558/15 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: (i) the fund's formation document which is obtained through a resolution by the fund's administrator; (ii) the fund's by-laws; (iii) statement provided by the the fund's administrator regarding the execution of contracts by the fund's administrator with the portfolio manager and other providers of services to the fund; (iv) disclosure of documents used for the distribution of shares; and, as the case may be (v) the prospectus; and (vi) the fund's national corporate taxpayer number.

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 ("FIEE"). 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"). On 2016, FIP regulation went through a deep change after enactment of Rule 578, by CVM on 30 August 2016, which revoked CVM Rule 391/03 and CVM Rule 209/94, and the enactment of Rule 579, by CVM on 30 August 2016, which regulates the preparation and disclosure of FIP's financial statements.

## 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 578/16 and according to this rule they are considered closed-ended funds. Such rule regulates the formation, operation and winding up of private equity funds.

CVM rule 578/16 consolidated different rules of already existing FIP categories (*Empresas Emergentes, Infraestrutura e Produção Econômica Intensiva em Pesquisa, Desenvolvimento e Inovação*) and had also created 2 new categories of FIP: *Capital Semente* (Seed Capital) and *Multiestratégia* (Multi-strategy). In the other hand, FIP fund of funds were extinted meanwhile FIPs were authorized to invest in another FIP according to the rules set forth in CVM Rule 578/16. The table below summarizes the new categories of FIP:

FIP CATEGORY	MAIN CHARACTERISTIC
Seed Capital	Companies with annual gross revenue up to R\$ 16 million in the year immediately prior to the FIP's first investment or said amount collectively in the last 3 financial years.
Emerging Companies	Companies with annual gross revenue up to R\$ 300 million in the year immediately prior to the FIP's first investment or said amount collectively in the last 3 financial years.
FIP-IE FIP-PD&I	Companies that develop projects in the industries of energy, transportation, water and sanitation, irrigation and any other industries.
FIP-PD&I	Companies in the field of research, development and innovation.
Multi-strategy	Those which does not fit in the other categories.

One of the most important characteristics brought by CVM Rule 578/16 is the possibility of investment in limited liability companies as long as they comply with the annual gross revenue requirement for invested companies by Seed Capital FIP and that the FIP effectively influences the management and the definition of their portfolio companies' strategic drivers.

The purpose of a FIP is to buy shares and securities convertible into shares or quotas 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 percent of its net worth in the above-mentioned assets.

Except for FIP-IE and FIP-PD&I, the investment in non-convertible debentures is limited to the maximum of 33% of the FIP's total subscribed capital.

CVM Rule 578/16 allows the FIP to grant advances for future capital increase (known in Brazil as "AFAC") on their invested companies provided that (i) the FIP holds shares of the company that will receive the AFAC; (ii) the FIP is expressly allowed to make the AFAC by its by-laws; (iii) the AFAC is made as an irrevocable and irreversible commitment by the FIP; and (iv) the AFAC must be converted into capital increase in the invested company within 12 months.

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 554 enacted by CVM dated as

of December 17, 2014 (“CVM Rule 554/14”), which will take effect from July 1st, 2015, (i) are the “professional investors”, (ii) individuals or legal entities with financial investments in excess of BRL 1,000,000 and that additionally attest in writing their qualified investor condition, (iii) individuals that have been approved in examinations of technical qualification or who have certifications approved by CVM as requirements for the registration of autonomous investment agents, securities’ portfolio managers, analysts and securities advisors, in relation to their own funds, and (iv) investment clubs, provided they have their portfolio managed by one or more quotaholder, that must be a qualified investor. Professional investors, in turn, are defined by Instruction n. 554/14 (i) as financial institutions and other institutions authorized to operate by the Central Bank of Brazil, (ii) insurance companies and special savings companies (*sociedades de capitalização*), (iii) pension funds, (iv) individuals or legal entities with financial investments in excess of BRL 10,000,000 and that additionally attest in writing their professional investor condition, (v) investment funds, (vi) investment clubs which have their portfolio managed by a portfolio manager duly authorized by the CVM, (vii) autonomous investment agents, securities’ portfolio managers, analysts and securities advisors, in relation to their own funds, and (viii) non-resident investors.

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. The placement of FIP’s shares can be directed to professional investors and after the 90 days lock-up period, among other rules set forth on Rule 476, enacted by CVM on 16 January 2009, the shares can be traded in the secondary market with qualified investors.

The FIP’s by-laws can regulate the existence of different economic/financial rights to one or more classes of shares with respect to: (a) administration and management fees; and (b) priority order with respect to payment of earnings, amortizations or the fund’s liquidation balance.

As a general rule, CVM Rule 578/16 provides that FIP must have a significant influence in the decision making process of the companies. Notwithstanding the above, CVM Rule 578/16 fails to establish an accurate meaning for “significant influence in the decision-making pro-

cess”. 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 578/16: (i) prohibition of the issuance of founders’ shares (*partes beneficiárias*), as well as cancellation of any existing founders’ shares; (ii) define an unified term of office of 2 years for the entire board of directors (when in exists); (iii) disclosure of (a) any agreements entered with related parties, (b) any shareholders agreements, (c) stock option programs or any issuer’s security option program; (iv) 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; (v) adopt arbitration as the conflict/dispute resolution mechanism; and (vi) annually audit its financial statements by an independent auditor registered with CVM.

Moreover, the FIP’s administrators must periodically provide documents and information to CVM on a three-months, semi-annual and annual basis. The most common information among the different types of investment funds are: (i) the fund’s net worth, the number of shares issued and the fund’s shareholders categories; (ii) the fund’s portfolio composition and diversification; and (iii) financial statements accompanied by the report of the independent auditors and the report of the administrator and the portfolio manager in respect of the operations and results of the fund.

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, the investors’ decision to buy, sell or keep these shares or the investors’ decision to exercise any rights connected to their condition as fund’s shareholders or any securities related to the fund’s shares. CVM Rule

578/16 determined that private equity funds must have their respective assets and liabilities valued and priced according to their fair value.

CVM Rule 578/16 kept the provision that, if permitted in the fund's by-laws, the administrator may provide a personal guaranty (*fidejutory* 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.

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 percent of their net worth in companies without the requirement of significant influence in the decision making process of these companies. This limit of 35 percent shall be increased to 100 percent 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 percent does not apply during the fund's disinvestment period with regard to each of the invested companies. FIPs are also authorized to invest up to 20% of its subscribed capital abroad provided that the invested assets have the same economic nature of the investments allowed for FIPs in Brazil. Multi-strategy FIPs targeted exclusively at professional investors may invest up to 100% of its subscribed capital abroad provided that (i) such provision is allowed at

the FIP's bylaws; (ii) the FIP's bylaws determines that the Fund targets exclusively professional investors; and (iii) the addition of "Investimento no Exterior" (*Investment Abroad*) in the fund's denomination.

Also, private equity funds cannot leverage through borrowing. However, the CVM Rule 578/16 kept the authorization for FIPs to receive financial support from financial agencies with the ability to obtain loans to leverage their investments in amounts up to 30 percent 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 ("IBD")) whose funds are provided mostly by a single or multiple governments, and controlled by one or multiple governments. Besides the obtainment of loans by multilateral organizations, development agencies or development banks, CVM Rule 578/16 also allowed the obtainment of loans by the FIP to pay-up unpaid FIP shares' subscribed by shareholders in default, provided that the loan shall meet the exact amount necessary to comply with the investment commitment previously taken by the FIP.

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

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After CVM Rule 578/16, the venture capital funds in Brazil so far limited to the Fundos de Investimento em Empresas Emergentes ("FIEE") (once ruled by CVM Rule 209/94, now revoked by CVM Rule 578/16), joined a new category of FIP - the *Fundos de Investimento em Participação - Empresas Emergentes* ("FIP-EE") and the *Fundos de Investimento em Participação - Capital Semente* ("Seed Capital FIP"). The Seed Capital FIP conception aims to foster the development of startups and small entrepreneurs on different fields. Both FIP-EE and Seed Capital FIP have the same portfolio's concentration limitations as the other FIP categories ruled by CVM Rule 578/16, observed the singularities of their respective invested companies as shown below.

The biggest innovation of CVM Rule 578/16 is the permission to Seed Capital FIP (and the other FIP categories, save for FIP-IE and FIP-PD&I) to invest in limited liability companies ("LLC"), provided that the invested LLCs must have annual gross revenue up to R\$ 16 million in the year immediately prior to the FIP's first investment or said amount collectively in the last 3 financial years. The LLCs, as long as they keep the above annual gross revenue limitation, are waived to implement some corporate governance practices such as the annual audit of its financial statements and the adhesion to the arbitration chamber for resolution of corporate disputes. After exceeding the annual gross revenue limit of R\$ 16 million, the LLC invested by Seed Capital FIP must transform into a joint-stock company and follow the governance standards stipulated by CVM Rule 578/16.

The companies invested by Seed Capital FIP cannot be direct or indirect controlled by a company or a group of companies (of actual or legal existence) which may have total assets over R\$ 80 million or annual gross revenue up to R\$ 100 million in the year immediately prior to the FIP's first investment. However, such rule does not apply if the company is controlled by another FIP, provided the FIP's financial statements are not consolidated at the financial statements of any of its shareholders.

On the other hand, observed the provisions of CVM Rule 578/16, the invested companies by FIP-EE must have annual gross revenue up to R\$ 300 million in the year immediately prior to the FIP's first investment or

said amount collectively in the last 3 financial years. The companies invested by FIP-EE are waived to implement the following corporate governance practices: (i) prohibition of issuance of participation certificates and non-existence of such securities in circulation; (ii) establishment of a unified mandate of up to 2 years for the entire board of directors, when it exists; and (iii) adhesion to the arbitration chamber for resolution of corporate conflicts. If after the investment by the FIEE the invested company's gross annual revenue exceeds the limit of R\$ 300 million, the invested company must comply with the governance practices set forth in CVM Rule 578/16 within a period of up to 2 years, counting from the closing date of the fiscal year in which its gross annual revenue exceeds said limit.

The companies invested by FIP-EE cannot be direct or indirect controlled by a company or a group of companies (of actual or legal existence) which may have total assets over R\$ 240 million or annual gross revenue up to R\$ 300 million in the year immediately prior to the FIP's first investment. As well as the Seed Capital FIP, this rule does not apply if the company is controlled by another FIP, provided the FIP's financial statements are not consolidated at the financial statements of any of its shareholders.

## 4. TAXATION OF FIP

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Due to the fact that investment funds are deemed to be a condominium, as mentioned above, in general, the proceeds from the sale of assets of its portfolio is exempt of Brazilian taxes (income taxes and tax on financial transactions "IOF") until income is distributed to its shareholders. In general, the gains obtained by the portfolio of the investment funds are exempt of withholding tax (WHT).

Any gains obtained upon sale or redemption of shares of FIPs by investors resident in Brazil, are generally subject to withholding tax at a 15 percent rate. However, where FIPs do not hold a portfolio comprising at least 67 percent 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 15% to 22.5%, 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 FIPs and FIEEs), as long as the foreign investor is duly registered with CVM and represented by a financial institution and the foreign

investment is registered in accordance with the new CMN Resolution No. 4,373/14. Non-resident investors are generally subject to the same taxation as resident investors. However, non-resident investors that invest in shares of FIPs in accordance with the CMN Resolution No.4,373/14 are subject to WHT at a zero percent rate in case such investor, alone or along with related parties, (i) does not hold 40 percent or more of shares of the fund; (ii) does not hold interests in the funds that grants such investor 40 percent or more of the fund's income; and (iii) is not resident in a jurisdiction that taxes income at a maximum rate of less than 20 percent and as long as (iv) the fund does not hold debt securities in representing a percentage higher than 5% of its net equity, save for public securities, convertible debentures and subscription bonuses.

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

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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 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 years, as a result of many factors, including (i) changes in regulation improving minority shareholders' rights, (ii) the creation of different listing segments by the São Paulo stock exchange, (iii) the increased participation of FIPs and (iv) the advocacy work performed by certain non-profit associations such as (a) the IBGC - Brazilian Institute of Corporate Governance, which published in 1999 the Code of Best Corporate Governance Practices (further revised in 2001, 2004, 2009 and again in 2015) and (b) the ABV-CAP - Associação Brasileira de Private Equity & Venture Capital, which has published The Venture Capital and Private Equity Guide in 2013 (updated in 2015) and the Code of Regulation and Best Practices for the Market of FIP and FIEE, published in 2011, created together with ANBIMA - Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais.

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 complement-

ing 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 IPOs, 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.

## ABOUT ABVCAP



Brazilian Private Equity &  
Venture Capital Association

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

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

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

ABVCAP's activities aims 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.

THIS GUIDE WAS WRITTEN BY

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A D V O G A D O S

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

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