JUNE 2009, RELEASE ONE

GCP
THE ONLINE MAGAZINE FOR GLOBAL COMPETITION POLICY

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Recent Developments in Brazilian Merger Control: The Case of Private Equity Funds

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In spite of the worldwide financial crisis, the industry of private equity funds in Brazil is experiencing a vigorous moment. According to the Brazilian National Association of Investment Banks, there are more than eight thousand private equity funds in operation, administering over five hundred billions of dollars invested in numerous sectors of the economy.[2]

As a result, Brazilian Competition authorities are being challenged with legal and economic questions regarding the analysis of potential anticompetitive effects arising out of transactions involving such funds.

As per the article 54, *caput*, of the Brazilian Competition Statute (Law 8.884/94), any given transaction—whether involving private equity funds or not—must be notified to the Brazilian Competition Protection System (the "BCPS") if it "presents potential risks to competition." This excessively wide filter is narrowed by the third paragraph of the same article 54, according to which a transaction is presumed harmful to competition and, thus, must be notified if: (i) it involves parties whose economic groups have registered, in Brazil, consolidated gross revenue of more than four hundred million *reais*[3]—currently equivalent to approximately two hundred million U.S. dollars—in the year preceding that of the transaction; or (ii) it results in over a twenty percent market share for any relevant market.

The notification must be filed within fifteen business days as of the signature of the first binding document upon the parties. Otherwise, they are subject to fines that may vary from sixty three thousand and eight hundred *reais* (R$ 63,800.00), up to six million, three hundred and eighty four thousand *reais* (R$ 6,384,000).

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[2] Detailed data available at www.anbid.com.br

[3] R$1.00 = U.S.$0.51 (June 8th, 2009)

The effective amount of the fine is defined on a case-by-case basis, according to the criteria set forth in the Administrative Rule n. 44/2007, of the Administrative Council for Economic Defense – CADE.[4] Among such criteria, Article 1, III of the Administrative Rule establishes that 0.005% of the arithmetical average of each party's[5] gross revenue, up to a limit of seven hundred and forty four thousand *reais* (R$ 744,000.00), shall be accrued to the fine.

The first set of questions that the BCPS has to face in connection with transactions involving private equity funds derives from the interpretation of the "economic group" concept. Do the actual investors—those who have invested their resources in the funds—constitute an "economic group" among themselves? If so, should the gross revenue criteria be applied to their income? What if the fund is opened to the market; that is, any person or legal entity can put their money into that fund? And what if the investors are, actually, entities that do not carry out business activities, such as pension funds, or even individuals?

On the other hand, do the investors and the targeted companies (those in which the administrator of the fund decided to inject the resources) constitute an economic group among themselves?

The answers to these questions are not trivial.

It is perfectly possible to conceive the hypothesis of an operating business company constituting a private equity fund with the objective of allocating resources in a specific sector or on specific companies. Should the target company be a competitor in the investor's market, then it will be absolutely reasonable to understand that there is an economic group among them. Then the gross revenue criteria must be fully applied, not only with regard to the obligation to notify the corporate transaction to the competition authorities, but also when it comes to the imposition of occasional fines for untimeliness.

However, in the vast majority of cases, the investors do not carry out activities in the same economic field of the targeted companies, do not carry out business activities at all, or they have no power to influence the administrators' decisions of investing in one or another company.[6] Therefore, the concept of "economic group" would hardly be applicable.

The problem is that it is impossible to know upfront what the characteristics of a certain fund are. And by extension of the argument, it is impossible to know in advance if a transaction involving private equity funds is potentially harmful to competition. In

[4] The entity in the BCPS vested in adjucative powers. The Portuguese version of Administrative Rule n. 44/2007 is available at www.cade.gov.br/upload/RESOLUÇÃO%20N.º%2044,%20de%2014%20de%20fevereiro%20de%202007.pdf.

[5] And respective economic groups, in Brazil, in the year preceding that of the transaction.

[6] By the way, it is exactly because the investors trust the experience and knowledge of the administrator that they agree to put money into his hands. It would seem incoherent, to say the very least, that they would want to interfere with the administrator's discretion.

other words, should the transactions involving equity funds be exempt from antitrust control, market players would be granted the golden possibility of carrying out anticompetitive transactions without the risk of having restrictions imposed by antitrust agencies.

Consequently, not only the "economic group" concept, but also the "gross revenue" criteria are being interpreted by CADE in a broad manner, as far as the obligation to notify a transaction involving private equity funds is concerned.

CADE defines "economic group," as a group of investors with a significant share in the equity fund (*i.e.*, above 5 percent of the total of quotas) or the ability to influence the investment decisions. "Gross revenue," by turn, is construed as the accountable income of an investor or that of the targeted company(ies). And in case the investor is not a business entrepreneur (such as pension funds), the respective patrimony will be taken as the proxy for application of the legal criteria.[7]

With regard to the imposition of fines for untimely notification, CADE has only decided two cases.

In the first case (AC #08012.000281/2008-39), CADE ruled that the aforementioned 0. 005 percent accrual should be levied upon the arithmetical average of (i) the gross revenues or patrimonies of the investors at the equity fund (whether they are business companies or not) and (ii) the gross revenues of the targeted company. The decision was heavily criticized by the private bar on the grounds that such an understanding could lead to a fine with a value exceeding that of the transaction or even the patrimony of the equity fund itself.

Very recently,[8] though, CADE rendered a unanimous decision on AC# 08012.000900/2009-76, ruling that (i) when there is no overlap, vertical integration, or complementarity between the business activities of the investors or respective economic groups and those of the targeted company; and (ii) the investors do not have the ability to influence the investment decisions of the fund's administrators, the former's gross revenues or patrimony should be deemed irrelevant. The 0.005 percent accrual, then, should be levied on the average of the patrimony of the equity fund and the gross revenues of all companies in which it holds any kind of stake, including the target of the notified transaction.

The basis of this new understanding is that the mere fact that legal entities or individuals are investing in the same equity fund does not necessarily imply that they are part of the same economic group. Besides, as long as the fund administrator has the

[7] This understanding was adopted unanimously in various cases, among which: AC # 08012.014090/2007-73; AC # 08012.010222/2008-79; AC # 08012.009072/2008-51; AC # 08012.007119/2008-41; AC # 08012.006082/2006-72; AC # 08012.000900/2009-76. Portuguese versions of these decisions are available at www.cade.gov.br.

[8] On May 27, 2009.

discretion to decide when and where to invest, it makes much more sense to consider the fund itself, on one hand, and the targeted companies, on the other, as the "groups" involved in the transaction.

It is not possible, at this time, to state that there is a tendency towards one or another interpretation. However, CADE is undertaking a series of meetings with representatives of the equity fund industry and of the Brazilian Securities and Exchange Commission, in order to refine its knowledge of the respective markets and improve the effectiveness of its decisions. Hopefully, these joint efforts will end up successfully.