PREMERGER CONTROL OF PRIVATE EQUITY FUNDS: THE BRAZILIAN PERSPECTIVE

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I. INTRODUCTION

As the Brazilian economy slowly regains traction, the country also returns to the whitelist of national and international private equity funds ("PE Funds"). In 2016-2017 alone, dozens of PE Funds — mostly from Brazil and the United States, but also from the United Arab Emirates, the United Kingdom, China and others — reported altogether more than 160 transactions with Brazilian companies as targets.

PE funds' strategies are sometimes based on market consolidation, i.e. the acquisition of companies in the same industry to gain certain competitive advantages. In view of that, one may ask whether the Administrative Council for Economic Defense ("CADE"), the Brazilian authority for antitrust related issues, find reasons for deeper scrutiny of private equity funds, and, if so, how is such analysis performed.

In this paper, we aim at answering the main questions related to the premerger control of private equity funds in Brazil. We begin by introducing the premerger control, in view of the changes in the competition policy in the last five years. We then explain whether CADE requires premerger approval for PE funds, the criteria, the timing, the information required, the analysis undertaken by the authority and the consequences of not notifying in due time. We end the paper with a summary and our conclusions.

II. PREMERGER CONTROL

Brazil adopted "*prior* premerger" control in 2011-2012. As redundant as it may sound, until then, notifications of mergers and acquisitions were typically done *after* the closing, and CADE could later decide to reverse it or to inflict restrictions to the transaction. Such administrative proceedings could last for several months or even years.

Things are remarkably better now. CADE has undergone relevant changes in its structure and legal mandate, and mergers and acquisitions which are subject to scrutiny must be *previously* cleared by CADE. Most notifications (97 percent) are nowadays decided at the first instance by the General Superintendence, instead of at the second instance by the Administrative Tribunal. This reorganization also resulted in the average duration of the administrative proceeding reduced from more than 150 days to less than 30 days.

The new scenario caused the number of notifications to decline from around 700 a year before 2012 to around 400 a year after it. This was due to clearer submission criteria. Before the law enacted in 2011, mandatory notification was triggered if a certain percentage of market share was reached, offering space to different interpretations with respect both to the definition of the market and the measurement of the market share. The law now requires transactions to be submitted only if the groups involved pass the Gross Revenue Test. There are additional rules applicable to investment funds and to minority stakes, which we explain further below.

We must say, however, that the rejection or any type of restrictions over transactions are still very limited considering the overall number of notifications (only 2.4 percent) — although very high among the cases challenged in the Administrative Tribunal (88.8 percent).

III. IS PREMERGER APPROVAL FROM TRANSACTIONS INVOLVING PRIVATE EQUITY FUNDS REQUIRED?

Perhaps to the surprise of some, it was only recently that CADE formed the understanding that transactions involving private equity funds should be subjected to premerger approval. As recent as 2012, for example, the authority spent more than 90 percent of a decision's length with considerations on whether the submission was required or not.

Indeed, under the ambiguity of the previous law, some methodologies have arisen by way of precedents to establish which investment funds' submissions could be waived. In a decision from 2002, the Administrative Tribunal recommended that premerger notification was not needed when done for the sole purpose of investment and pursuant to the ordinary business of the fund, provided that there was no influence over the commercial strategy of the company or, if so, it be solely to prepare the company for the partial or total sale, and as long that such control does not last more than a year. In another precedent from 2010, two additional criteria were included: the submission could be waived if investors did not have enough power to affect fund managers and the fund manager did not have enough influence over the target company.

A similar exemption was included in the bill of law of the current Brazilian Competition Act, dismissing the premerger control of temporary transactions with the purpose of resale, which lacked capacity to determine or to influence the competitive behavior of the target company or funds which only used political powers to prepare its resale.

However, not only this exemption was excluded from the last version of the bill. CADE later came to acknowledge that private equity funds were indeed subject to premerger control – provided that the following criteria were met.

IV. IN WHICH CASES MUST PRIVATE EQUITY FUNDS SUBMIT PREMERGER NOTIFICATIONS?

There are currently three tests to establish whether a private equity transaction must be submitted to CADE's approval: (1) the Gross Revenue Test, which depends on the definition of economic group and of the economic group of investment funds, and (2) the Equity Test or (3) the Convertible Bond Test.

- The Gross Revenue Test establishes that a transaction should only be notified if (a) one of the economic groups involved had higher turnover in Brazil than R$ 750,000,000.00 (roughly U.S. $230,000,000.00) in the last year, and (b) another economic group involved had higher turnover in Brazil than R$ 75,000,000.00 (roughly U.S. $23,000,000.00).

  The definition of economic group for the Gross Revenue Test include (a) all companies under common control, as well as (b) all companies where companies under common control hold at least 20 percent of the share capital or voting capital.

  In the context of investment funds, the definition of economic group considers (a) the economic group of each quotaholder holding 50 percent or more of the fund, individually or by any contractual means, (b) the targets controller by the fund or where the fund holds at least 20 percent of the share capital or voting capital.[2]

- The Equity Test establishes that the transaction should only be notified if (a) they result in the acquisition of individual or shared control of the target; or (b) in the event the target company is not a competitor nor has activities in the same supply chain: (b1) the buyer directly or indirectly acquires 20 percent or more of the share capital or voting capital; or (b2) at each additional acquisition of 20 percent or more of the share capital or voting capital; or (c) in the event the target company is a competitor or has activities in the same supply chain: (c1) the buyer directly or indirectly acquires 5 percent or more of the share capital or voting capital; or (c2) at each additional acquisition of 5 percent or more of the share capital or voting capital.

- The Convertible Bond Test establishes that any transaction based on bonds convertible in equity should be notified if (a) the convertible rights meet the levels set forth in the Equity Test, and (b) the buyer has the contractual right to nominate managers or supervisors, or has veto rights to competitive issues.

V. WHEN SHOULD PRIVATE EQUITY FUNDS REQUEST ANTITRUST APPROVAL?

Once identified that a transaction is subject to premerger filing, under the criteria set forth in the previous section, then the parties involved must submit the notification to CADE before any post-merger integration.

It has been questioned whether the investment agreement signed by the quotaholders could already be considered an associative agreement, requiring proper notification, since it is an agreement which establishes the share of risks and results between the parties, and the quotaholders may be competitors in the same relevant agreement. Although CADE has not issued an opinion on this matter yet, we understand that a specific antitrust approval should not be required for the fund's investment agreement because of the lack of economic activity of the fund, which will only provide such economic activity by means of the acquisition of target companies.

2 Before 2014, the definition of the economic group of the investment fund included all funds under the same management, the fund management itself, all quotaholders with 20 percent or more of any investment funds under the same management and all portfolio companies of each fund under the same management. In October, 2014, the references to the fund manager were excluded and the economic group limited to the fund directly participating in the transaction.

VI. WHAT INFORMATION WILL THE BRAZILIAN ANTITRUST AUTHORITIES REQUIRE?

Transactions considered simple – such as joint-ventures, the substitution of an economic agent, low market shares in the same geographic areas or in the same supply chain, HHI lower than 200 (if market share is lower than 50 percent), and other cases which are considered simple by the General Superintendence – can be notified under the summary procedure. In 2016, 80 percent of the notified transactions were considered simple.

If the General Superintendence considers a transaction as complex, it must be notified under the ordinary procedure. In both procedures, the parties will be required to deliver information and documents about the transaction, the history of transactions, the parties involved in the transaction and their economic groups. All documents related to the transaction, either in their final form or in their most recent versions, must have copies delivered to CADE, as well as any other agreements which may affect the political powers of the parties in the transaction.

It is worth noting that the definition of the economic group of the investment fund for the purpose of disclosure is different (and much wider) than the one established in the Gross Revenue Test. Here, the economic group must include (a) the fund involved in the transaction, (b) the funds under the same management (if related to the transaction relevant market), (c) the fund manager, (d) the economic group of the quotaholders directly or indirectly holding 20 percent or more of the fund involved in the transaction, (e) target companies controlled by or whether the fund involved in the transaction holds 20 percent or more of the share capital or voting capital; and (f) target companies controlled by or whether the fund under the same management holds 20 percent or more of the share capital or voting capital (if related to the transaction's relevant market).

Furthermore, all participation equal or higher than 10 percent in the share capital or voting capital of a company in markets related to the transaction, by any part of the economic group, shall also be disclosed to CADE, including the corporate structure chart.

Additionally, in the ordinary procedure, the parties will be required to describe other competitive aspects, such as the relevant market, by the supply side and the demand side, alternatives to sell, entrance and rivalry conditions and coordination.

Misleading or false information, document or statement will subject the responsible party to fines of up to R$ 5,000,000.00 (around U.S. $1,533,000.00) and to a new premerger control of the transaction, if applicable.

VII. HOW IS THE ANALYSIS OF ANTITRUST ISSUES UNDERTAKEN?

During 2016-2017, CADE reviewed a few mergers and acquisitions concerning investment funds, and all of them were approved without restrictions. The main defense accepted by the General Superintendence was that the targets held insignificant parcels of market share or that there was no overlapping with other companies of the same group, considering in particular the geographic area.

In the Concentration Act n. 08700.007133/2017-88, acquiring party Terraverde SA, controlled by a Brazilian Private Equity fund, sought to buy a stake of 32,1 percent of Lavoro Agrocomercial Ltda, a company active in the markets of seeds, pesticides and fertilizers.

During its analysis, the main issue raised by CADE was a possible vertical integration in the fertilizer market between Lavoro and an undisclosed company controlled by the same private equity fund. Nonetheless, CADE accepted the parties defense, which stated that both the undisclosed company and Lavoro had its own distributions networks and a reduced market share, setting aside any concerns regarding vertical integration. The merger was approved with no restrictions[3].

CADE also faced issues regarding investment funds in the Concentration Act n. 08700.007007/2017-23. In this matter, FIP Pirineus, a privately managed fund owned by the Tradener Group, and highly active in the renewable energy market, intended to buy 67,5 percent of the voting shares in Rondinha Energética S/A, operator of a small dam in Southern Brazil. The targeted shares were owned by Atlantic S/A and the merger would result in the exit of Atlantic.

3 Additionally, the General Superintendence understood that the market shares were much too small to impact competition directly. The numbers are not publicly disclosed, but according to the analysis made by the Superintendence, even an eventual vertical integration would not be able to close the relevant market for competitors.

The merger was analyzed through the lens of two relevant markets: energy generation and energy trading. After collecting and evaluating data both from the regional and national market, CADE's opinion was that the merger would not affect competition neither in horizontal nor vertical markets, due to the low market shares of the parties. The merger was also approved without restrictions.[4]

Another operation that was approved by CADE with no restrictions was between Archy, LLC and Actis ED. Archy is a holding company, fully owned by GIC Ventures, and Actis ED is an investment fund owned and managed by several Latin-American funds, having investments in distinct economic sectors in Brazil. The proposed merger consisted in the acquisition by Archy, directly or indirectly through one of its subsidiaries, of the shares owned by Actis in Cruzeiro do Sul Educacional S/A, which has activities in the basic and higher education market.

The most important point in this case is that CADE acknowledged that there could be horizontal issues regarding the merger, but did not evaluate the merits of the concentration act, because CADE understood that the companies had businesses in different relevant markets.

We have not observed different analysis with regard to private equity, other than to the elements described in this paper – such as the definition of the economic group of investment funds. Overall, as mentioned, CADE is still renitent to inflict restrictions, and the large majority of transactions submitted are timely approved.

Additionally, since the establishment of the premerger control in 2012, CADE has enforced the necessity of timely notification before any closing or post-merger integration acts. Pursuant to article 88, section 3, of Law 12,529/2011, parties that fail to notify CADE in due time are subject to gun jumping fines of up to R$ 60,000,000.00 – roughly U.S. $18,000,000.00.[5]

VIII. CONCLUSION

In this short Q&A paper, we intended to provide the reader with an objective view of the premerger control in Brazil of transactions involving private equity funds. As we have noted, CADE has been historically more concerned with establishing tests and procedures on when and how to submit premerger fillings, than to perform deeper analysis on competitive consequences of said transactions. This may explain the low level of rejections and restrictions imposed by the authority in this context so far.

Even though, the applicable transactions must be notified to CADE in the due time. No closing and no post-merger integration may occur before the decision of the authority, otherwise the parties can be subject to high penalties. We have named the criteria which determine whether a transaction must be submitted or not as the Gross Revenue Test, the Equity Test and the Convertible Bond Test.

On the bright side for market players, premerger fillings are mostly done under the summary procedure, with simplified the amount of data and documents to be provided. Organization changes undergone by CADE in the last five years have also remarkably reduced the duration of the administrative proceeding, which in most cases is not greater than 30 days.

4 It must be borne in mind that the energy sector in Brazil has undergone unprecedented changes since the 1990s. Besides energy generation and energy trading, transmission and distribution are also very important relevant markets, even though they did not play a role in this specific case. Competition matters regarding regulated sectors usually raise various sorts of concerns, especially relating to relevant markets when analyzing a merger.

5 In order to explain and to solve questions regarding gun jumping, CADE published its "Guide for Premerger Analysis" in 2015, which can be found in its official website.