Compliance due diligence in the context of securities offerings by Brazilian issuers

Introduction

Despite the economic and political crises that have gripped Brazil in recent years, the Brazilian sovereign's loss of its investment grade rating, and the prevalence of Operation Carwash (*Operação Lava Jato*)[1], debt and equity securities issued by Brazilian issuers have been attractive to foreign investors. A recent increase of capital markets activity by Brazilian issuers indicates that foreign investors continue to look to Brazil for investment opportunities.

As a result of the widespread reporting of corruption and the ongoing Operation Carwash investigations in the national and international press, one of the first red flags raised by foreign investors and banks when deciding to invest in securities issued by Brazilian companies is the results of the compliance and anti-corruption due diligence undertaken with respect to such potential issuers. Even prior to the Operation Carwash investigation, investment banks and institutional investors involved in securities issuances exhibited great concern in connection with compliance policies and risk assessment with respect to Brazilian entities which, in part, lead to the enactment of Law No. 12,846, dated August 1, 2013 (Brazilian Anticorruption Law) (as further described herein).

The main purpose of this article is to describe the importance of conducting effective compliance due diligence to address applicable laws such as the **Brazilian Anticorruption Law**, the U.S. Foreign Corrupt Practices Act (**FCPA**) and the Bribery Act 2010 of the United Kingdom (**UK Bribery Act**), as well as risk mitigation and reputational concerns, all in the context of securities offerings by Brazilian issuers into the international capital markets.

Overview of International Placement of Securities Offerings by Brazilian Issuers

In Brazil, securities offerings are subject to a number of rules and regulations that have been enacted by the local securities regulator, the Brazilian Securities Exchange Commission (*Comissão de Valores Mobiliários*) (**CVM**). From a U.S. law perspective, international placements of securities issued by a Brazilian issuer are typically offered and sold under the exemptions from registration required pursuant to the U.S. Securities Act of 1933, as amended (**U.S. Securities Act**), such as those provided by Rule 144A of the U.S. Securities Act (**Rule 144A**) as well as the exemption provided for non-U.S. persons under Regulation S of the U.S. Securities Act (**Regulation S**).

In respect of offerings of equity securities, which typically are undertaken by means of an initial public offering (**IPO**) or follow-on offerings, applicable Brazilian laws require that an offering prospectus containing the terms of the securities in question and related matters (prospecto) and a disclosure document containing detailed information with respect to the issuer (*Formulário de Referência*) are filed with the CVM. The content and format of such disclosure are governed by a fulsome set of rules and regulations. A key requirement is that the documentation filed with the CVM must be in Portuguese. For the purposes of securities offered to investors outside of Brazil, typically an offering memorandum is also prepared in English containing the terms and conditions of such equity securities and related matters, as well as disclosure regarding the issuer, utilizing the disclosure standards applicable to transactions undertaken pursuant to the exemptions from registration available under Rule 144A and/or Regulation S.

1 In March 2014, while conducting a small investigation involving a local gas station/carwash in the city of Curitiba (state of Paraná, Brazil), the Brazilian Federal Police and the MPF uncovered evidence of a much larger corruption and bribery scheme involving Brazil's state run oil company, Petrobras. Shortly after Brazilian authorities became aware of the scheme, a federal investigation, dubbed Operation Carwash (Operação Lava Jato), was initiated and is being conducted by Federal Prosecutors and the Federal Police with the support of a Federal Judge, Sérgio Moro. Operation Carwash was initially thought to involve high-ranking employees of Petrobras and several of the country's largest construction companies. However, after the arrest of certain key individuals, such as Petrobras' former Director of Refining and Supply, Brazilian authorities became aware that the scheme was a billion-dollar operation involving numerous politicians and political parties. Operation Carwash is still ongoing and it has spread around other sectors of the Brazilian economy.

Therefore, Brazilian qualified lawyers prepare the local offering disclosure and other documents required for filing with the CVM and otherwise execute the offering to investors in Brazil, with the input of the other parties to the transaction, which should include foreign underwriters or placement agents and counsel (which are typically U.S. qualified lawyers) retained for the international leg of an equity offering, such as an IPO with sales of shares to investors outside of Brazil.

With respect to offerings of debt securities by a Brazilian issuer, the debt securities are typically offered and sold in private placements pursuant to an exemption from registration under the U.S. Securities Act, in many cases by using the exemptions under Rule 144A and Regulation S, as described above. Unlike equity securities offerings by Brazilian issuers listed in Brazil, debt securities offerings by Brazilian issuers do not need to be filed with the CVM. Thus, only an offering memorandum in English containing the terms and conditions of such debt securities and disclosure regarding the issuer need to be prepared for the purposes of providing the requisite information to potential investors, as required by the U.S. Securities Act, Rule 144A and Regulation S.

While Rule 144A contains less fulsome disclosure requirements when compared to an offering registered with the U.S. Securities Exchange Commission (**SEC**) under the U.S. federal securities laws, market practice and general U.S. anti-fraud considerations have developed to the effect that U.S. investors in offerings made pursuant to Rule 144A expect disclosure standards similar to what would otherwise be required for transactions subject to SEC registration. Thus, the relevant SEC disclosure standards are used as guidance by international counsel in preparing the offering documents (with some exceptions).

However, a misstatement or omission of fact in the applicable disclosure document could open parties involved in the securities offering (including the investment banks, the issuer's shareholders, officers, and directors, as applicable) to legal proceedings instituted by investors and in some instances, enforcement actions by U.S. and European regulators. In order to mitigate this risk, the drafting process, business due diligence, bring down due diligence and compliance due diligence must be carefully managed by the parties involved in the respective securities offering.

Compliance Due Diligence

Under Brazilian law, compliance is a set of measures to prevent or mitigate the risk of violation of laws in connection with an activity carried out by a person (e.g., shareholder, officer, director, employee or a third party service provider contracted by the issuer). In addition, compliance strengthens the internal controls of the issuer, mitigating risks to the issuer's reputation and reflecting transparency and high ethical standards, generating more value and credibility for its shareholders and investors.

The need for conducting an in-depth compliance due diligence in the context of securities offerings by Brazilian issuers cannot be analyzed without further observation of the Brazilian political and macroeconomic scenario. A turbulent political and economic environment, coupled with popular protests in June 2013, lead to the legislative action needed to cause the enactment of the Brazilian Anticorruption Law, which was approved in 1 August 2013, by the then President Dilma Rousseff. The Brazilian Anticorruption Law became enforceable in January 2014 and further regulations were issued in March 2015 which imposed the need for Brazilian companies to have an effective compliance program.

Three years later, on 31 August 2016, the then President Dilma Rousseff was found guilty in an administrative proceeding conducted by the upper house of the Brazilian legislature during an impeachment procedure. As a consequence, President Dilma Rousseff was impeached and removed from office and Vice President Michel Temer became President for the remainder of Ms. Roussef's term, which ends on 1 January 2019.

Considering the political scenario described above and the ongoing Operation Carwash, their ramifications in other sectors of the economy and the involvement of large Brazilian companies, politicians and their political parties, undertaking compliance due diligence has become an essential requirement to executing securities offerings by Brazilian issuers in order to prevent, or mitigate, the risks of legal proceedings to be brought by the investors and regulators, as well as reputational risks to institutions involved in such transactions (including investment banks involved in the marketing and/or underwriting of such securities).

Despite the political scenario in which the Brazilian Anticorruption Law was enacted, this legislation was considered innovative in imposing liability on companies and their officers, directors, and shareholders. Strict liability applies to the company in question, as no intent to commit corruption needs to be found in order for a company to be convicted under the Brazilian Anticorruption Law. The law may also allow for the piercing of the corporate veil in order to reach shareholders of the company in question. In addition, should the company interfere in public biddings, including the competitive nature of such biddings, it could be found guilty under the new Brazilian Anticorruption Law.

In the context of securities offerings by Brazilian issuers, a compliance due diligence is a prior investigation conducted to identify any potential liability of the issuer before the launch of the offering, in order to prevent risks involved in the offer for underwriters. It may also involve setting out a strategy to mitigate liability of the parties involved in the offer. How thorough a compliance due diligence is undertaken will very much depend on the issuer's circumstances and the risk perception by the underwriters. It therefore varies from a set of tailored questions addressing all aspects of the issuer's compliance policies and procedures, coupled with media review of the company, its shareholders and directors, and judicial searches, to a complete due diligence which mirrors an internal investigation.

A fulsome compliance due diligence will contain the following elements and work product:

- document review;
- background check of key individuals;
- fact interviews with officers, directors and key employees of the issuer; and
- an analysis of internal practices, policies and relevant information, which should include, among other things, (a) a description of the business activities and where such activities are conducted; (b) information about political exposed persons and interactions with government officials; (c) accounting and finance controls; (d) off-balance sheet transactions; (e) relationships with external auditors; (f) charitable and political donations; (g) gift policies; (h) third-party intermediaries; (i) policies and procedures with respect to commercial bribery; (j) policies and procedures with respect to participation in public biddings; (k) policies and procedures with respect to conflicts of interest; (l) policies and procedures with respect to sanctions and embargoes; (m) policies and procedures with respect to privacy and cyber security; (n) judicial and administrative proceedings; (o) permits and licenses; and (p) compliance with the Brazilian Anticorruption Law, the FCPA and the UK Bribery Act, as applicable. Depending on the applicable company's exposure to the FCPA or UK Bribery Act, other activities can be undertaken.

Upon conclusion of an effective compliance due diligence, it should be possible to identify the contingencies (whether or not such contingencies have materialized), that may result in risks to the offering and to the issuer, and also some strategies may be proposed by the counsels to resolve or mitigate risks that could impose liability on or reputational harm to parties involved in the securities offering. In addition, compliance due diligence process serves as a great opportunity for the issuer to verify that all internal practices and policies are being conducted in compliance with applicable laws and market practice, thereby reducing the possibility of judicial and administrative procedures being brought by applicable regulators or investors.

One of the strategies to mitigate the risk of a class action brought by future foreign investors arising from a corruption scandal that becomes public after the settlement of the securities offering, is the proper disclosure of the potential acts of corruption in the applicable offering disclosure, disclosing the current status of ongoing investigations and, as the case may be, the dismissal of the persons involved in the respective corruption by the issuer. Compliance due diligence will assist in identifying any such risks so that proper disclosure can be included in the applicable offering memorandum.

In addition, the representations and warranties made by the issuer under the placement facilitation agreement or underwriting agreement (in offerings of equity securities) or the note purchase agreement or subscription agreement (in offerings of debt securities), as applicable, should include an issuer's statement or selling shareholders' statement in respect of such entity or individual's compliance with the Brazilian Anticorruption Law, the FCPA, and the UK Bribery Act, as applicable. Undertaking a fulsome compliance review is necessary in order to allow for the individual or entity making such representations to be in a position to accurately make the requisite declarations or otherwise address the subject thereof with the other parties to the proposed securities offering (such as the investment banks). These representations are of critical importance to investment banks involved in the marketing and/or underwriting of securities, given the risks inherent in participating in offerings in the current environment.

Conclusion

Due to the current national political and economic scenario, Brazilian companies are incorporating the compliance culture into their own daily practices, observing and respecting investors' requirements of undertaking compliance due diligence as part of an international offer of securities. This measure has become essential to companies that want to receive foreign investments and compete for funds in the international capital markets. Given that there is international interest in eradicating corruption around the world, it is no longer acceptable for companies who wish to tap the market not comply with the demands of the Brazilian Anticorruption Law and the standards set by the FCPA and the UK Bribery Act.

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