Brazilian Equities

The re-opening of the Brazilian equity markets to foreign investment through increased IPO activity

Introduction

The year 2017 marked the return of new equity capital markets issuances by Brazilian companies, after several years of relative inactivity due, in part, to a number of political scandals that became public in 2014. The most notorious political scandal, known as *Lava Jato* (Car wash), which involves widespread corruption and ongoing investigations by Brazilian authorities, has had far reaching implications, leading to Brazil's worst recession in years[1]. The inflow of capital and investments from international investors into Brazil experienced a dramatic decrease from pre-scandal levels, as investors have waited for increased political stability and economic growth before investing large amounts of capital in the country. As a result, from 2014 to 2016, only three Brazilian companies (one per year) were able to access the capital markets by means of an IPO. Those three IPOs had an aggregate value of approximately US$570m[2].

Beginning in 2016, current president Michel Temer's economic team has sought to implement measures focusing on more effective management of public expenditures and budgetary restraints (with varying levels of success). Those measures have to some extent contributed to the recovery of investors' confidence in investing in Brazil, even in light of the on-going political scandals. This increase in confidence is evidenced by the recent flurry of IPO activity during the last year. There was a significant increase in IPOs listed on the São Paulo Stock Exchange – known as **B3**) in 2017– ten IPOs were successfully executed during the last year, raising an total aggregate amount of approximately US$6,476m (based on the current US Dollar / Brazilian *Real* exchange rate, as such transactions are executed in Brazilian *Reais*). There has also been increased issuance activity by existing Brazilian public companies. In 2017, Brazilian companies with securities already listed on B3 issued and sold additional equity securities (follow-on equity offerings) in an amount of approximately US$6,324m (based on the current US Dollar / Brazilian *Real* exchange rate).

In addition to the increase in the number of IPOs and follow-on equity offerings executed during 2017, indications are that high levels of activity should continue during the first half of 2018, as a number of other companies have filed or are intending to file issuer registration requests with the *Comissão de Valores Mobiliarios* (**CVM**), Brazilian regulatory authority equivalent to the U.S. Securities and Exchange Commission (**SEC**). While the expectation is that IPO activity will continue in 2018, upcoming federal elections in October 2018 could limit the window for such transactions.

Overview of the IPO process in Brazil

In Brazil, equity securities offerings are subject to a number of rules and regulations that have been enacted by the local regulators. According to CVM regulations, the local IPO process involves two registrations (one with respect to the registration of an issuer and one with respect to the equity securities to be registered). Both registrations can be, and normally are, filed simultaneously as a single request with the CVM. The CVM's review process usually takes approximately eight to ten weeks from the initial filing, allowing for two to three rounds of comments from the CVM.

Once the registration process has been initiated with the CVM, prospective issuers may start to produce

1 In 2015 and 2016 Brazilian GDP exhibited negative growth of 3.8% and 3.6%, respectively. Another two-year recession period has only happened once, in 1930 and 1931, and has exhibited negative GDP growth of 2.1% and 3.3%, respectively. (source: *Instituto Brasileiro de Geografia e Estatística* – IBGE)

2 Ouro Fino Saúde Animal Participações S.A. (ticker: OFSA3) in 2014; Wiz Soluções e Corretagem de Seguros S.A. (ticker: WIZS3) in 2015; and Centro de Imagem Diagnosticos S.A. (ticker: AALR3) in 2016.

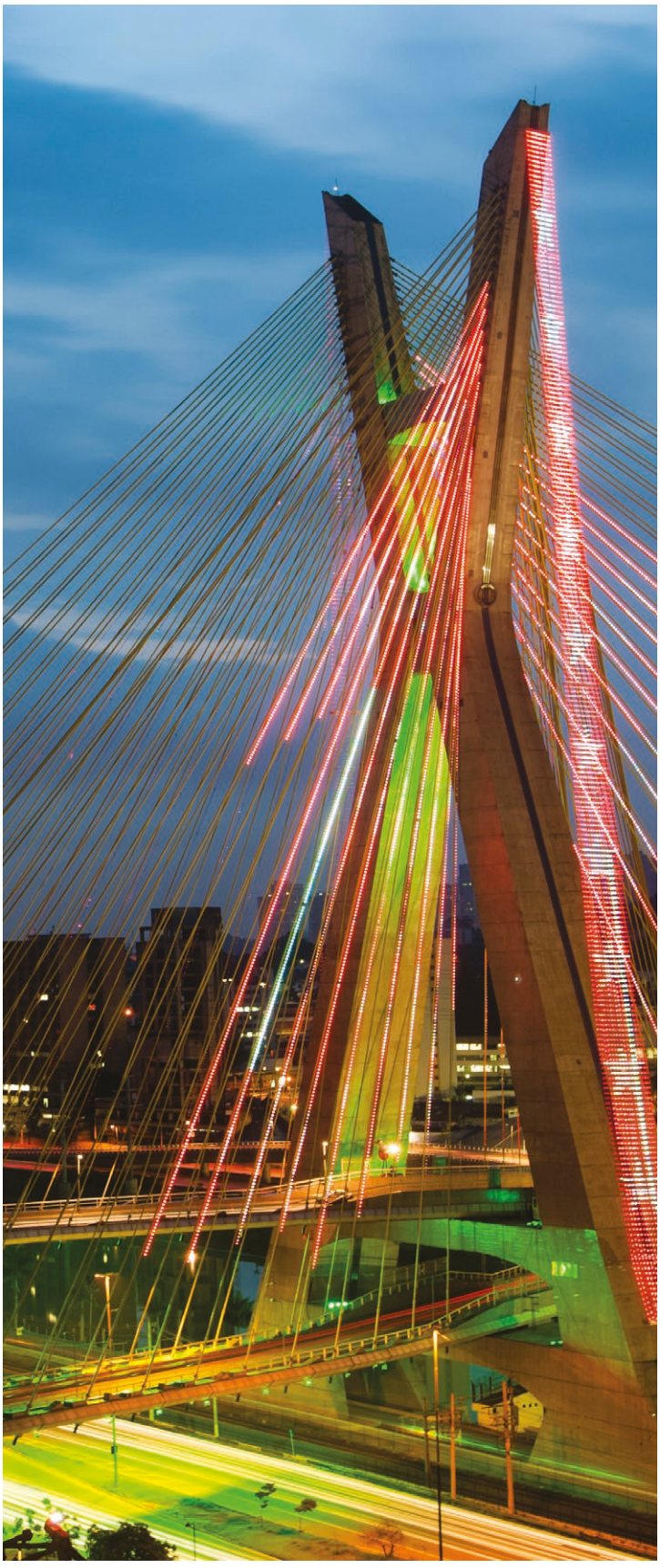
a preliminary prospectus and initiate marketing and book-building arrangements with respect to the contemplated IPO. However, a prospective issuer and the underwriters in an offering will typically wait until the first round of comments have been received from the CVM in order to have some level of confidence that there are no major regulatory impediments to pursuing the intended public equity offering.

Upon the grant of the registration of the offering by the CVM, the prospective issuer and the underwriters may proceed with announcing the transaction to the market and publishing and distributing the final offering disclosure on public websites. Such publication of disclosure sets the timeline for the beginning of the trading of shares on the B3.

From a U.S. law perspective, shares issued in a Brazilian IPO executed and listed on B3 are typically offered and sold in private placements utilizing the exemptions from registration under 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 the exemption provided for non-U.S. persons under Regulation S of the U.S. Securities Act (**Regulation S**).

Selected Issues in Executing an IPO in Brazil

The IPO process for an issuer seeking a listing in Brazil is a complex process with a number of issues that must be considered in order to ensure the successful execution of the contemplated transaction. The following is a high-level discussion of a few of the more critical sets of issues to be considered.



Disclosure

Further to the earlier discussion regarding the local filing requirements, Brazilian securities laws require that an offering prospectus containing the terms of the securities in question and related matters (*prospecto*) and disclosure document regarding the issuer (*Formulário de Referência*) be filed with the CVM. The content and format of this disclosure is governed by a fulsome set of rules and regulations. One such key requirement is that the documentation must be in written in Portuguese. Brazilian qualified lawyers prepare the local offering disclosure and other documents needed for filing with the CVM and otherwise executing the local offering (offering to investors in Brazil), with the input of the other parties to the transaction, which include underwriters as well as lawyers retained for the international leg of the IPO (which are typically U.S. qualified lawyers).

The sale of securities to investors outside of Brazil are typically made pursuant to the exemptions to registration under the U.S. federal securities laws pursuant to Rule 144A as well as applicable provisions in other jurisdictions. While Rule 144A does not contain specific disclosure requirements (as would be the case for an offering registered with the 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 were the transaction to be registered. As such, the relevant SEC disclosure standards are used as guidance by U.S. counsel in preparing the offering documents (with some exceptions).

Difficulties arise when preparing the Portuguese language local offering disclosure for purposes of the requisite CVM filings and English language offering disclosure to be used in connection with the offer and sale of securities to investors outside of Brazil. The two sets of disclosure have to mirror each other in terms of substance, as investors must be provided with the same level of information on which to base an investment decision [in both languages]. A mismatch between the information disclosed in the local offering disclosure and in the international offering disclosure could open up the parties to an IPO to legal proceedings from investors and in some instances, enforcement actions by regulators. In order to mitigate this risk, the drafting processes with respect to the local offering disclosure (in Portuguese) and of the offering circular for the international offering (in English) must be carefully managed by the parties to a transaction. In practice, the parties involved in the IPO transaction discuss, negotiate, and work in the documents used in the local offering and once the transaction progresses and filings have been made with the CVM, the international transaction documentation is drafted to reflect the negotiated terms and disclosure.

Equity Research Reports

While equity research reports are a common feature in offerings of equity securities by issuers in many jurisdictions, they remain a critical component to an IPO that merits review and analysis by parties to any such transaction. Equity research reports are prepared by financial institutions to provide an analysis to be used by investors in a particular issuer's securities In the U.S., the Financial Industry Regulatory Authority (**FINRA**), a self-regulatory entity for the financial services industry, has a number of rules addressing potential conflicts in the content and distribution of

such reports. These rules address a key concern that research reports prepared by a financial institution could be subject to conflict of interest where the institution is also involved in the marketing of the securities as underwriters. In this circumstance, the financial institution may be tempted to prepare research that is favorable to the issuer and the transaction in question rather than providing a more independent assessment of the merits of the offering. The FINRA rules focus on requiring information barriers and similar safeguards within a financial institution between deal team members (those bankers working on an IPO) and the research analysts who prepare research guidance to be used by potential investors, as well providing restrictions with respect to the timing of publication of any such report during "quiet periods" relating to the offering in question.

While larger financial institutions have robust internal policies and mechanisms to address the preparation and publication of equity research reports, these institutions rely on their external U.S. counsel working on the transaction to prepare research report guidelines and provide specific guidance relevant to a particular transaction. This guidance includes the preparation of detailed equity research guidelines containing a detailed discussion of restrictions on content (such as: avoiding projections and limiting coverage to information otherwise provided to investors through the transaction disclosure), timing of publication and interactions between analysts and members of a transaction deal team. In addition to preparing guidelines for use by the underwriters, international counsel to the underwriters is relied upon to review the draft equity research reports ahead of their publication to ensure compliance with the relevant guidelines.

In addition to the FINRA rules in the U.S., there are specific rules imposed in Brazil by the CVM regarding the content of any equity research report and restrictions on their distribution in connection with transactions registered with the CVM. Most likely, an international counsel prepares guidelines with respect to U.S. law considerations and market practice, while a Brazilian counsel to the underwriters provides them with written guidelines with respect to compliance with CVM rules. As such, international and Brazilian counsels must work closely to provide clear guidance to the underwriters with respect to all elements of the research report process.

Selling Shareholders

Where an IPO involves a "secondary" offering (sales of already issued shares by one or more selling shareholders), there may be sensitivity on the part of the prospective issuer and the relevant selling shareholders as to how selling shareholders should be treated with respect making certain representations and for purposes of the underwriters' indemnification, particularly when the selling shareholders are entities that are controlled by Brazilian federal, state or municipal governments.

Therefore, a point of sensitivity when dealing with a governmental selling shareholder or one controlled by a Brazilian governmental entity is to what extent such selling shareholder can be deemed as an "insider" of the issuer for purposes of making certain representations and warranties as well as providing indemnification to underwriters in the context of the proposed IPO transactions. As a matter of risk allocation, underwriters typically require that selling shareholders provide the same level of indemnification and make representations in line with the corporate issue of the securities in question. However, governmental

shareholders may not have the same level of involvement in the day-to-day operations of a corporate issuer and may thus be reluctant to provide the same level of representation coverage and indemnification as would other parties selling shares in an IPO.

Conclusion

Indications are that the Brazilian economy has begun to expand and increasing amounts of capital will be needed to finance such growth. Following several years of modest issuance activity, Brazilian issuers may be increasingly more likely to access the equity capital markets to finance their operations. Despite market challenges arising from the on-going political scandals in Brazil, the recent IPO activity demonstrates that international investors have an increased appetite for equity securities issued by Brazilian issuers. However, economic activity in emerging markets such as Brazil can be volatile and issuance activity can quickly freeze as a result of systemic pressures and shock events, including federal elections such as those scheduled to take place in Brazil later this year.

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