Investment Committees in Brazilian Private Equity Funds

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One of the distinguishing features of the Brazilian private equity environment is the significant number of private equity funds in which the investors have decision-making powers with respect to the fund's investments through a seat in the investment committee.

From a regulatory standpoint, the presence of an investment committee is optional. Most Brazilian private equity funds are structured as "FIPs"[1] and, as such, they are not obligated to have such a governing body. There is also flexibility in establishing the composition of the investment committee: members can be primarily appointed by the GPs or by the investors. Although the role of an investment committee can vary, it will usually have the final say on the investments – and divestments – proposed by the GPs. In some cases the committee will also monitor the GPs' activities and have veto power over certain matters along the investment process. The rules governing the existence, composition and functions of the investment committee will be set forth in the FIP's by-laws.

At first glance, one could find some similarities between the investment committee so often used in Brazil and the advisory board common in more developed PE&VC industries worldwide. However, the role of the advisory board is essentially focused on advising and supporting funds in their investment activities rather than on actually making investment decisions.

The reason behind the widespread use of investment committees is usually attributed to the profile of Brazilian investors. The main private equity investors in Brazil are institutional investors, such as pension funds, and they customarily require a seat – or in many cases the majority of seats – in the investment committee to closely oversee the investment strategies of the GP and to be able to block any investment they deem to be too risky or overvalued. The participation in the investment committee, some investors argue, also enables them to develop an expertise in private equity investing, which is useful for the selection of GPs in future rounds of investment.

Advocates of the investment committee contend that a balanced and well-structured committee can greatly improve the fund's governance. It would encourage investors and GPs to foster a closer business relationship, increase transparency and thus lead to better qualified investment decisions.

[1] Please refer to Issue No 4 of our newsletter for an overview of the tax advantages of the FIP. Available at http://www.loboeibeas.com.br/publicacoes/ma-private-equity-newsletters.

Not everyone shares this opinion, though. Investment committees – as structured in Brazil – are subject to much criticism.

The main point of criticism is not the actual existence of the investment committee, but its functions and composition. Many market players point out that investors should not have the majority of seats in the committee, nor the power to block important decisions. They stress that the whole purpose of private equity investing is to enable investors to benefit from the experience of independent GPs with strong financial incentives to make the best decisions on behalf of the fund. After all, would it make sense to agree to a sophisticated compensation package for the GPs but afterwards leave final investment decisions with the investors? Additionally, the predominant presence of investors in an investment committee can slow down the fund's decision-making process. And, in some extreme situations, cause the fund to lose good business opportunities. An investors-controlled investment committee would also be an obstacle for raising capital from investors located in the United States or other countries where investors normally do not take part in the fund's investment decisions.

In light of such criticism, corporate governance advocacy groups argue that rather than allowing investors to interfere in key business decisions, funds should improve their corporate governance standards to provide more comfort and transparency for investors. Their message may be getting through. The creation of compliance committees responsible for overseeing the conformity of the fund's activities and observance of its by-laws, instead of investment committees, has become a more frequent phenomenon in the Brazilian PE&VC environment.

It is perhaps too soon to determine whether an investors-controlled investment committee is a permanent feature or merely a phase in the development of the Brazilian private equity industry. In such a rapidly evolving industry, any prediction must be viewed with caution. But it does seem that, as Brazilian investors accumulate positive experiences from private equity investing and start to rely more on GPs' track records, they will probably feel less need to have a final say on funds' investment decisions.

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