

Impediments to Risk Capital in Argentina, Brazil, Chile, El Salvador and Mexico

By Morrison & Foerster LLP



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The Multilateral Investment Fund (MIF) was created in 1993 to encourage private sector development in Latin America and the Caribbean with a special emphasis on microenterprise and small business. In partnership with governments, business organizations and NGOs, MIF provides a mix of technical assistance grants and investments to support market reforms, help build the capabilities of the workforce, and broaden the economic participation of smaller enterprises. Stimulating new approaches to private sector development and sharing lessons learned are central to MIF's mission. The following is one in a series of independent discussion papers that assess current private sector development needs.

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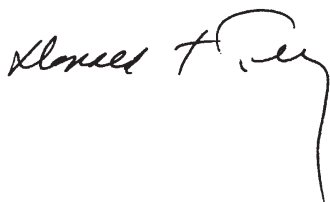
I am pleased to present this Report analyzing how the current legal and regulatory frameworks in Argentina, Brazil, Chile, El Salvador and Mexico affect private equity and risk capital flows into small and medium size enterprises (SMEs).

Risk capital investment in Latin America has grown over the last five years. However, fund managers operating in the region are confronting limitations in legal and regulatory frameworks that can discourage this type of investment. Although macroeconomic and market factors are fundamental to an investment decision, legal frameworks also have a very significant impact. There is a need to push forward with reforms if risk capital investment is to continue to grow.

Specialized intermediaries and a supportive legal and tax environment have spurred private capital growth in many developed economies. Countries that want to attract foreign investment, particularly into their SME sector, should ensure that their respective legal frameworks provide an attractive environment for investment.

This report outlines a series of actions in terms of legal frameworks that could help to promote financing through risk capital to SMEs in Latin America and the Caribbean. The report was produced jointly by Morrison & Foerster LLP and the Inter-American Development Bank / Multilateral Investment Fund (MIF). In sharing this report, the MIF hopes to stimulate consideration of steps to promote innovation and economic growth.

Sincerely,

A handwritten signature in black ink, appearing to read "Donald F. Terry". The signature is fluid and cursive, with a long, sweeping line extending from the bottom of the name.

Donald F. Terry
Manager, Multilateral Investment Fund

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By Morrison & Foerster LLP*

with the cooperation of:

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I. INTRODUCTION

This report examines aspects of the legal and regulatory frameworks of Argentina, Brazil, Chile, El Salvador and Mexico which impact risk capital and private equity flows into small and medium size enterprises (“SMEs”). By risk capital or private equity¹ we refer to arms-length investments made by third parties in enterprises with a high risk profile by virtue of such factors as the absence of operating history and unproven markets for their goods and services.²

Risk capital investment is a form of financial intermediation through which companies receive financing primarily from investment funds, which in turn are financed by investors seeking high returns from their investments. The largest pool of risk capital in Latin America is now composed of private equity funds, as is the case in the United States, Europe and Asia. A study by the Federal Reserve Board staff suggests why:

Because little information about firms that issue private equity is publicly available, outside investors must engage in a significant amount of due diligence and post investment monitoring. These activities are not efficiently performed if the outside equity is widely held; consequently, most outside equity is held by private equity intermediaries.³

Most equity fund managers raise capital primarily from pension funds and insurance companies that invest billions of dollars among various types of investments. There are also large financial institutions such as The Chase Manhattan Bank and Citibank that have separate private equity divisions. The key to understanding how legal frameworks affect risk capital is to view it from the perspective of the main activities that fund managers perform for their investors: (1) deal origination, (2) due diligence, (3) structuring investments and (4) managing and exiting investments.

Risk capital investment in the countries surveyed and in Latin America as a whole is of recent vintage. The United States was the first place in which risk capital became a specialized industry. Although in existence for decades, the industry took off in the 1980s with the proliferation of limited partnerships investing in technology oriented start ups. Since then and up to the present private equity represents a major source of funding for new companies in the United States. Private equity funds targeting Latin America began in the early 1990s and grew exponentially during the last half of the 1990s. There are now over fifty such funds with total aggregate commitments exceeding almost US\$20 billion.⁴

The increase in risk capital investment in Latin America over the last five years is a product of the economic growth in the region and a credit to the policies and reforms put in place by local governments. Fund managers in the region, however, have confronted limitations in local laws and regulatory regimes. These limitations have had the unintended consequence of detracting risk capital investment and illustrate a need for continued reform so that risk capital investment continues to grow in Latin America. Current obstacles affect the ability of fund managers to invest amounts committed by their own investors and impact all stages of risk capital investments. In Brazil and Argentina, for example, and in varying stages in the other countries studied, contingent liabilities such as past due taxes, pension funds and environmental liabilities are frequently mentioned as a problem for due diligence and company valuations. Prohibitions against redemption of shares or uncertainties regarding the validity of warrants limit or make more costly the range of structures available to fund managers making investments in all countries. Standard contractual protections prevalent in the risk capital industry may not be available in some countries. For

¹ The term “risk capital” is used in this report interchangeably with “private equity” although some fund managers consider private equity to be later stage investments and not necessarily risk capital. Like others, we consider venture capital investments to be a segment of private equity, and both categories to fall under the term “risk capital.”

² Family and friends of entrepreneurs make risk capital investments, but their investment decisions are motivated by definition by relationships in addition to any potential returns. Strategic investors are also risk capital investors but they may also driven by factors other than return on the investments per se. So called “angel investments” are not a major factor in risk capital investments in Latin America in the opinion of many market participants.

³ George W. Fenn, Nellie Liang and Stephen Prowse, “The Economics of the Private Equity Market,” Board of Governors of the Federal Reserve System, 168 Staff Study (1995): 43.

⁴ Latin Finance estimated 19.2 billion by the end of 1999. See Paul Kilby, “Heading for the Exits,” Latin Finance (May 1999): 31. The preliminary estimate for 2000 is 5 billion.

example, voting agreements are unavailable in Mexico. Moreover, even when there are no outright legal prohibitions to a contractual mechanism, there are significant issues of “enforceability” of key contractual rights and statutory protections for minority rights. The combination of limitations, prohibitions or restrictions collectively act as an unintended disincentive to private equity investors. As discussed throughout this report, limitations to private equity, in general, have a disproportionately negative effect upon investments in SMEs.

While market and macroeconomic factors are key drivers of risk capital flows, legal regimes in and of themselves have a significant impact on such investments. The creation of the limited partnership vehicle in the United States and changes in the tax laws are widely credited as a major factor in the exponential growth of private equity in the United States.⁵ Thus, countries that wish to encourage facilitating risk capital flows, in general, and into SMEs, in particular, should examine closely the need for changes in their respective legal frameworks.

A. Methodology

We have employed a straightforward methodology to identify shortcomings in the laws and regulations that affect risk capital investing. Four local law firms, in addition to Morrison & Foerster’s Buenos Aires office, surveyed (on a pro bono basis) each of their countries’ relevant legislation and shared with us their perspective on the subject in the form of detailed country reports (“Country Reports”). These firms were: (1) Levy & Salomao of Brazil, (2) Guerrero, Olivos, Novoa y Errazuriz of Chile, (3) Delgado & Cevallos of El Salvador, and (4) Creel, García-Cuellar y Muggenburg of Mexico. Each of the firms also hosted workshops in the respective countries, which were attended by fund managers, government officials, and interested local professionals. In addition, the Multilateral Investment Fund and the Banco Multisectorial de Inversiones provided additional support. Fund managers and other professionals involved in private equity in the region were also interviewed. We proceeded to take the information obtained from the Country Reports and workshops to identify common themes and potential approaches to finding solutions to the problem areas identified.

B. Organization

Section II of this report sets forth a summary of the principal findings of the Country Reports, workshops and interviews. The results are wide-ranging and cover items under the relevant local corporate and tax laws and regulation of stock exchanges. Many of the problem areas apply to most of the countries studied, while some are more country specific. To facilitate review of problem areas by countries, there is a comparison table attached as Annex 1.

Section III sets forth a more in depth analysis of what most private equity practitioners perceive to be key issues that require changes in the local laws in order to facilitate private equity investments. These issues relate to problems with the structuring of investments, focusing on the de facto prohibition against creating stock option plans and the issuance of warrants. This section also discusses issues that are viewed as detrimental to minority investors.

Section IV analyzes legal issues with respect to risk capital exit strategies. Unlike the issues discussed in section III, the legal issues related to exit mechanisms are more related to contract enforceability than to statutory limitations per se. Finally, Section V suggests a range of potential approaches to overcome the legal obstacles discussed in Sections III and IV.

5 See “Venture Capital in OECD Countries,” Organization for Economic Cooperation and Development No. 63 (February 1996): 15.

II. SUMMARY OF PROBLEM AREAS

The Country Reports and discussions with fund managers reveal that there exists significant overlap among the problem areas risk capital investors identify with Latin American countries. This Section summarizes some of the problem areas and identifies those areas that are discussed more fully in Section III.

A. Regulatory Hurdles.

The hurdles to foreign investment presented by Latin American laws and regulations are found primarily in the formal controls on capital inflows and outflows and the restrictions on investment in certain industries. A discussion of the relevant regulations derived from the Country Reports is found in Section III.

B. Limitations on Investment Structures.

The lack of flexibility in local corporate laws to create certain types of securities or instruments is a universal problem. As further discussed in Section III, tax and corporate laws severely limit the creation of stock option plans and warrants and limit the cost-effective alternatives for structuring risk capital investments in the countries studied.

C. Lack of Accounting Conformity.

Local practitioners and risk capital investors alike complain about the difficulty in carrying out due diligence and valuation because of the way books and records are kept by local companies. A major problem is the absence, in practice, of country-specific standardized accounting principles and the incompatibility of local practices with U.S. GAAP.

D. Corporate Governance and Minority Rights.

Corporate governance procedures and the availability and enforcement of shareholder rights generally present problems for risk capital investors. In particular, the absence of effective protection for minority shareholders is seen as a problem in all five countries, and this and other related matters are discussed in Section III.

E. Contingent Liabilities.

Risk capital investors in Latin America confront difficulties in evaluating contingent liabilities when conducting due diligence. The Argentina and Brazil Country Reports indicate that contingent liabilities such as back due taxes, social security contributions and environmental liabilities are a major concern. As a general matter, private equity investors are often wary of the characterization of, or ability to quantify, contingent liabilities by local companies in the context of acquisitions throughout the countries studied. An example is the treatment of tax audits in all five countries. Tax audits may not be final determinations, i.e. they do not permit representations to be made by target companies with respect to payment of all taxes as of a closing date, even if the companies have been audited recently by local or federal taxing authorities.

F. No Waiver of Preemptive Rights.

Preemptive rights exist and are explicitly protected under the corporate laws of all of the countries studied. For example, Argentina and Brazil severely restrict the circumstances under which preemptive rights can be waived. Under Mexican corporate law, shareholders cannot agree in advance to waive their pro-rata preemptive rights to subscribe for future issuance of shares by a company. The absence of prospective waivers of preemptive rights hinders the ability of investors to build into legal documents mechanisms commonly used in private equity transactions, whereby shareholders agree to certain dilutive events or changes in equity percentage ownership between investors and other shareholders. Typically, a waiver of preemptive rights permits investors to have more flexibility in that they can restrict or increase their equity stake in a target company based on future performance

by the company or its management, additional financing, and certain other significant corporate events. Therefore, the impossibility or limitations of these waivers takes away this flexibility.

G. Voting Rights.

In Mexico, shareholders cannot be bound to vote or refrain from voting their shares a certain way in the future, which makes enforcing risk capital transaction shareholder agreements problematic unless a trust vehicle is used, as discussed in Section III.

H. Investment Fund Legislation.

Legislation governing investment funds in the countries is perceived to be restrictive and can work against attracting risk capital investment at the local level. In Chile, the laws establishing Fondos de Inversion de Desarrollo de Empresas (FIDES) were created to channel capital from that country's wealthy pension system to SMEs. However, these laws are overly restrictive in their protection of the pension funds and have not resulted in facilitating the flow of local capital to Chilean SMEs.⁶ Similar vehicles in Mexico have had limited success, known as Sociedades de Inversion de Capital, they are less restricted than FIDES but still contain obstacles to the free flow of capital to SMEs. With respect to Fondos Emergentes in Brazil, local practitioners have complained of the time needed to get a fund approved and the restrictions of having to report daily net asset values. In Argentina, the absence of clear legislation and poor performance of the local economy has made for very little financing of SMEs by local investment funds. Finally, in El Salvador there is no legislation specifically governing investment funds at all.

I. Local Stock Exchanges.

Initial public offerings on the local stock exchanges of the countries studied have not proven to provide a viable exit strategy for risk capital investors. Market appetite for new issues is, of course, critical to the success of the local exchange, but it has not flourished for SMEs. Market participants in Brazil point out that there is virtually no appetite for risky start ups among domestic investors. The best that can be done from the regulatory standpoint is to have regulations that facilitate rather than hinder potential SME stock offerings.

Argentina, for example, recently passed regulations providing for the creation of a new class of stock issuances for corporations developing activities such as e-commerce, telecommunication technology, Internet and biotechnology.⁷ The objective of the new law is to facilitate access to the capital markets for start-ups. The listing requirements for these new offerings are less onerous than those required for established companies.

J. Restrictive Pension Fund Legislation.

Pension funds in Latin America hold billions of dollars and would appear to be a good source of money for risk capital investments and IPOs in the five countries studied.⁸ However, much of the legislation that created these pension funds restricts them from investing in start-up companies, and with the limited exception of Chile, pension fund capital has not been channeled into equity investment with any degree of success.

⁶ FIDES cannot take minority positions in portfolio companies, nor can one investor account for more than 25% of a FIDE's assets.

⁷ On December 28, 2000 the Argentine National Securities Commission passed Resolution No. 362/2000.

⁸ Pension funds in the ten largest economies in Latin America control \$145 billion in assets. As reported in Mike Zellner, "Jubilación Activa," Latin Trade Vol.9, No. 1 (Enero 2001): 47.

III. LEGAL ISSUES AND BARRIERS RELATED TO RISK CAPITAL INVESTMENT

Fund managers in the United States and Europe are accustomed to flexible corporate law regimes that provide for a wide variety of enforceable legal instruments to structure their investments. In contrast, foreign and domestic investors considering Latin American companies find less variety of legal and capital structures and less flexibility in the local corporate laws. The results of the Country Reports confirm the sentiment among risk capital investors that the legal frameworks in Latin America do not adequately provide the variety of legal instruments or the enforceability of those available necessary to meet the capital structures commonly used in risk capital investments. Risk capital investors seek to replicate, as much as possible, investment structures that reflect practices developed over decades and through complete cycles of investments. Corporate laws in the countries examined, although developed, are not designed to facilitate private equity or risk capital investments. This Section III highlights some of the main legal limitations cited by fund managers and local lawyers as handicapping private equity flows, which limitations include ineffective protection of minority interests, availability of capital structures, and regulatory hurdles on capital flows.

A. Minority Shareholder Protections.

A common source of complaints from fund managers is the absence of effective minority protections in certain jurisdictions and the difficulty of enforcing those rights that do exist when they try exercising them. Such is the distrust of minority protections that certain very large funds are reluctant to enter into any transactions with a Latin American company that does not involve their acquisition of a controlling interest.

Most local lawyers and fund managers agree that the problems related to minority shareholder rights are due partly to the legal frameworks but mostly to the manner of the enforcement of such rights by local courts. Indeed, all of the countries studied all have varying degrees of minority protections in their commercial codes. For example, in Brazil, Chile and Argentina minority shareholders have the right to vote on certain major corporate transactions.⁹ In each country, in the event of a decision contrary to minority shareholders' votes there are dissenter's rights pursuant to which minority shares are bought out at book value.¹⁰ In some of the countries there may not exist any recourse if the economic value of the shares is higher than book value, which diminishes the value of the minority protections.

B. Redemption Rights.

A concrete example of where local corporate laws regarding capital structures create disincentives to risk capital from abroad are the restrictions, in varying degrees in each country observed, on the ability of companies to buy back their own shares. Such restrictions on share redemption limit the effectiveness of put options commonly built into shareholder agreements in private equity transactions. In particular, the put rights that are affected are those (commonly requested by investors) that force the Company to buy back the investors' shares at a given price under certain circumstances.¹¹ Also, redemption is commonly found in the rights of preferred equity holders in risk capital financings. Risk capital investors may request the right to require the company to redeem their stock after a set amount of time (typically between five and seven years) and at an agreed-upon rate of return. These rights, among others (e.g., liquidation and dividend preferences) form part of the terms of the preferred stock being issued to investors. Redemption is often requested by investors who are taking a minority position in a company because mandatory redemption may allow them to get their money out in the event the company has no real prospects for going public or being acquired. Therefore, redemption features can serve to provide added comfort and an exit strategy for risk capital investors, though they are unfortunately not feasible in the countries we studied.

In Mexico, the law specifically prohibits private companies from buying back their own shares unless it is judicially ordered for the purpose of satisfying credit obligations. In the case of share redemption Mexican law

⁹ These can include merger, spin-off, transfer of substantially all of the assets of the company, creation of a class of shares with superior rights.

¹⁰ In Brazil it is possible for shares to be purchased at less than book value if certified by independent appraisal that the economic value of the minority shares is less than book value.

further provides specific procedures and requirements (e.g. shares redeemed by lot before a notary public). In El Salvador shares can only be redeemed pursuant to a court ordered public auction or adjudication, and held for a maximum of three months before they are again sold or the corporation is forced to reduce its capital. In Argentina, companies may only redeem their shares under limited circumstances. These include situations where redemption is done to cancel shares prior to a reduction in share capital or where it avoids a “great harm” to the company, although what constitutes a great harm may not be consistently applied by the local court system. Restrictions also exist under Brazilian corporate law under which companies may only buy back their own shares with company profits, reserves, or if the shares are “donated.”¹² Further, in Brazil any decrease in capital is dependent on the existence of losses to be absorbed or where the capital is shown to be excessive, and must further be approved by general meeting of shareholders. In Chile, redemption of shares is restricted to situations where minority shareholders do not approve of a major transaction for a company (e.g. change of control, creation of shares with superior rights) in which case the company must repurchase the minority shareholders shares.¹³ The inability to ensure that a company will in the future be able to buy back its own shares limits the implementation of put options. Risk capital investors can react to this uncertainty by seeking alternatives less favorable to a target company, such as setting aside a certain percentage of target shares in escrow, by using offshore holding companies or trust vehicles (in the case of Mexico).

C. Voting of Shares.

In Mexico the corporate laws prohibit an agreement among shareholders in an S.A. to vote their shares in a particular manner in the future. This makes voting agreements commonly found in shareholders agreements unenforceable and puts in question the future enforceability of provisions requiring majority shareholder consent, such as approval for an initial public offering and other significant corporate events. Fund managers and local lawyers have addressed the unavailability of voting covenants by attempting to ensure compliance through self executing mechanisms and the creation of shareholder voting trusts. The latter is most common and involves the deposit of shares with a trustee who is instructed, pursuant to a trust agreement, to vote the shares a certain way and under certain circumstances pursuant to the instructions of the investor. Negotiations of shareholder voting trusts can be drawn out, as they are effectively a mechanism to force compliance by shareholders of otherwise unenforceable undertakings (under local law) within a shareholders agreement. However, from the perspective of fund managers, voting covenants are not only common but necessary corporate governance provisions in order for them to be comfortable making risk capital investments in developing countries.¹⁴

D. Capital Structure Issues: Stock Option Plans and Warrants.

The corporate laws of countries contain de facto prohibitions against the creation of stock options, warrants, or similar instruments permitting its holder to buy a specified amount of stock at a specified time for a pre-set price. These instruments are often vital components in both venture capital and later-stage risk capital investments, but with the limited exceptions in Brazil and Chile are not enforceable or even feasible under the commercial legal regimes currently in place in the countries studied.¹⁵ The new economy start-up companies that sprung up and were based in Latin America in 1998-99 were unable to structure their first round venture capital financings with employee stock options. This forced nearly all of these companies to set up holding companies offshore so that such options could be issued, which in turn meant additional transaction costs for the start-ups as well as for their investors.

Employee stock options and similar instruments are a vital compensation component for founders, management and key employees in start ups and the amounts and vesting periods for options are heavily negotiated with venture capital investors. In the U.S., the types of awards that may be granted under a stock incentive plan include options, stock appreciation rights, dividend equivalent rights, restricted stock, performance units, and

¹² Law No. 6,404/76, Article 30, 1(b).

¹³ The Ley de OPAs discussed in Section provides for certain exceptions.

¹⁴ Jean Michel Enriquez, “Recurring Legal Issues for Private Equity Funds in Mexico,” Latin American Law and Business Report No. 8, Vol. 7 (August 31, 1999): 24.

¹⁵ In Brazil the issue of subscription bonds is a possibility. Even in Brazil, however, rights of preference exist for shareholders in relation to such bonds, and this may impair their use in risk capital transactions.

performance shares. Option awards are the most commonly used and formal U.S. State and federal regulations dictate how a “stock option plan” must be implemented to meet stringent corporate, tax and labor laws. Of particular interest to recipients of incentive stock options is their tax treatment in the U.S. as capital gains and not ordinary income. At the corporate structure level, a company sets aside a certain percentage of its authorized but unissued stock under a stock option plan approved by its board of directors. Stock option plans thus permit a company to grant a future equity stake that serves the dual purpose of rewarding the grantee the upside if the company’s value increases while ensuring that the employee stays with the company a certain amount of time in order to get such profit. The latter is achieved through the granting of options that vest over a certain period, typically three or four years, thereby limiting how much equity an employee has in a company’s first few years.

However, the legal frameworks of the countries studied restrict the ability of companies to have authorized but unissued shares, effectively preventing employee incentive stock options and similar instruments, none of which currently exist in Latin America.¹⁶ In Argentina, for example, the dual concept of issued share capital and authorized share capital does not exist: all share capital must be subscribed for when issued and any issuance of shares must be preceded by a share capital increase duly approved by the valid vote of the company’s shareholders as set forth in its bylaws.¹⁶ Therefore, the future issuance of shares under any circumstances is not something to which a corporation in Argentina can be bound legally.

Later stage risk capital investment structures often include the issuance of warrants, which are certificates that operate like stock options with the distinction that they are not necessarily granted to persons employed by the issuing company. Warrants can be used in private equity transactions as an added equity incentive, often referred to as a “sweetener” or “kicker”, which permits the investor more upside profit in a company if things go well in the future without forcing the company to give up more equity than it may want at the time of a given transaction. Warrants can also provide an equity upside for subordinated debt lenders. Unfortunately, the same impediments to the existence of stock options in the countries studied also apply to warrants. To continue the Argentine example above, the only possibility that exists for a risk capital investor to acquire warrants in a target company is to negotiate an agreement with all of the company’s shareholders. Under such agreement the shareholders would need to agree to (i) vote for the approval of the issuance of a certain number of shares at a certain price at a future date, and (ii) prospectively waive any pre-emptive rights. Local practitioners surveyed reported that this structure was plausible but cumbersome and had not been used in recent years. In any case, it would not provide a suitable alternative because it relies on future actions to be taken by shareholders as opposed to constituting obligations on the part of a company.

E. Regulatory Hurdles.

Currency exchange controls and industry specific limitations on foreign investment are the main regulatory obstacles faced by foreign risk capital investors in certain Latin American countries. Both of these types of obstacles can be time consuming and present additional transaction costs. Of the countries studied, only Brazil and Chile have laws that require central bank or similar monetary authority approval for payments abroad by domestic companies (e.g., dividends, distributions of proceeds from stock).

In Brazil, foreign investments in a Brazilian company are subject to registration with the Central Bank within 30 days of the investment. No approval is necessary for the remittance abroad of dividends, net profits, or proceeds from the sale of stock up to the amount of the investment. In the case of remittances of principal exceeding an original investment amount, however, Central Bank approval is again needed. In order to save time and avoid the approval process, foreign investors have the option of using an alternative approval called “international remittance of national currency.” The latter involves depositing local currency in a cash account held by a foreign financial institution domiciled in Brazil which in turn is authorized to convert the amount deposited into foreign currency for payments abroad. This latter method is recommended by local practitioners in Brazil, as it is can be more expeditious and cost effective than the approval process.

¹⁶ With the limited exception of what is permitted under Chile’s recent Ley de OPAs discussed in Section V.

¹⁷ Art. 186, Ley de Sociedades Comerciales N° 19,550.

In Chile, Decree Law 600 of 1974 (“DL 600”) regulates any foreign investment over US\$1,000,000. Foreign risk capital investors must seek prior regulatory approval from a government agency (Comité de Inversiones Extranjeras) and the approval process can take longer than a month. After approval under DL 600, a contract must be entered into with the Chilean government, pursuant to which, among other things, the foreign investor agrees not to remit the investment abroad for a one-year period. At the one-year mark, the foreign investor once again must apply to the Comité de Inversiones Extranjeras to remit capital abroad, which can take several weeks. Although they are undoubtedly valid elements of monetary policy addressing other concerns in their respective economies, these approval processes are hindrances for fund managers and foreign risk capital investors considering investments in Brazil and Chile. Although the required procedures are routinely followed by foreign investors in each country, their streamlining or elimination outright would expedite risk capital investments which often are on short timeframes to in order to capitalize on local market conditions.

Many Latin American countries regulate investment by foreign investors in certain industries. In some industries foreign participation may be barred outright, while in others the government may set limits on such participation. Of the countries studied, El Salvador offers the most open foreign investment laws in that it affords investors from abroad close to the same treatment as domestic investors. Argentina, Chile and Brazil in varying degrees restrict foreign ownership of media, including in some cases participation in newspaper companies, radio and television stations. Brazil also currently restricts any increase of foreign participation in the domestic financial system, while Chile also has additional restrictions in the fishing and marine transport industries.

Of the countries studied, Mexico has the most stringent regime for a long list of diverse sectors which are referred to there as “regulated industries.” Fund managers and venture capitalists considering an investment in one of Mexico’s many regulated industries must factor in the additional costs and time of obtaining pertinent government approvals. Among the regulated sectors in which foreign investment is proscribed outright are petroleum, nuclear energy, electricity, postal services, petrochemicals, radio and television. Other regulated industries require an approval from a regulating agency (“CNIE”) and, depending on the industry, there are percentage limitations on foreign investment. For example, there is a 25% maximum on investments in domestic air transport and a maximum of 49% in entities dedicated to port administration and telecommunications. In addition, any investment over 49% in twelve additional sectors¹⁸ also requires approval by CNIE. All applications by foreign investors to CNIE must be resolved by the agency within a forty-five day period, which period can seem long to opportunistic foreign risk capital investors. In addition to the required approvals from CNIE, additional regulatory approvals from other agencies are necessary for foreign investment in certain types of financial services and banking, insurance, brokerage, radio and television.

F. Trusts and Offshore Holding Companies.

Private equity funds rely heavily on offshore holding companies to overcome shortcomings in local laws. At its most basic level the structure entails having all the shares of an operating company in Latin America owned by a company organized outside of Latin America. Problems related to flexible capital structures, such as prohibitions on share redemption and authorized but unissued share capital, generally do not exist under the laws of the off-shore jurisdictions chosen for risk capital investor holding companies. Similarly, stock option plans are devised at the holding company level to avoid the problems that we have earlier identified in the countries studied. Argentina witnessed perhaps the most vigorous foreign venture capital financing activity of internet start-up companies in recent years, and offshore holding companies were repeatedly used.¹⁹ In Mexico the use of offshore holding companies is less common due to the flexibility of trusts, which are further discussed below.

The use of offshore investment vehicles to facilitate foreign risk capital investment in the countries of this report is a strong indication of the legal and regulatory barriers faced by such investors looking to invest in SMEs. Because risk capital investment is costly in terms of due diligence, legal and other costs, investment size is a key consideration for fund managers. The need to invest offshore forces an additional layer of transaction costs, mostly in local government filing and legal fees. Almost by definition investments in SMEs are smaller than investments in larger enterprises. As such, transactional cost involved by offshore legal engineering often are not easily absorbed by an SME investor.

¹⁸ These sectors include, among others, private schools, legal services, cellular telephony, perforation for petroleum and gas projects.

The use of trusts is another alternative risk capital investors use to get around problems they may perceive in the substance or enforcement of local law. In Mexico there has been widespread use of trusts (“Fideicomisos”) of their flexibility and enforceability. Mexican trusts basically allow for the disposition of property (e.g. shares) to be placed under the control of a trustee who is bound by the relevant trust agreement to carry out certain acts in the future under certain circumstances. Fees charged by trustees are high in Mexico, so cost is a deciding factor on whether trusts are utilized in a given transaction. This has a disproportionate impact on smaller companies (because investments by funds are correspondingly smaller), which can often mean that the cost of a trust may make the transaction prohibitively expensive. In Chile, Brazil and El Salvador, there is no trust vehicle available. Argentina has a fairly recent trust law²⁰ which to date has not been put to use as extensively as Mexico’s. The attractiveness of the trust in Mexico reflects the need to have mechanisms in place offering a high degree of enforceability without resort to litigation.

G. Taxes.

The tax laws of the countries surveyed present serious problems for risk capital investors. The problems are at different levels, including potential double taxation of gains at the company level and the distribution level of a private equity fund. There are also issues related to taxation on the companies themselves, the level of capital gain rates or uncertainties about such rates, and stock option plan tax treatment.

With respect to company income taxation, for example, in Brazil companies pay as many as 56 separate taxes.²¹ In Mexico, the Country Report points out that there are onerous tax provisions related to funds or investment channeled through off-shore vehicles organized in certain tax haven jurisdictions. In Chile, Workshop participants worried that because of lack of clarity in the tax laws investors could be taxed up to 45% while the applicable rate should be 15%.

Another important dimension of tax laws’ impact on private equity is the tax treatment of stock option plans. In Argentina, for example, it is an open issue as to whether companies issuing stock options can be taxed on these as compensation.²² In El Salvador there could be double taxation problems related to capital gains at the company and fund level because there is no legislation dealing with taxation of funds as there is in other jurisdictions.

²⁰ Ley 24,441 (1994).

²¹ Holly Johnson and Robert Pease, eds., *Latin American Private Equity Review and Outlook* (Wellesley: Asset Alternatives Inc., 2000), p.56.

IV. EXIT STRATEGIES.

Risk capital investors expect their fund managers to deliver returns to them within the agreed duration of a fund, which is usually seven to ten years. Fund managers try to analyze and structure their investments in Latin American companies to ensure that they are able to sell investments and channel the proceeds (net of their compensation) to investors in a timely manner. For this financial intermediation model to work successfully fund managers must be able to sell their investments at a profit and on time.

A growing concern manifested in the Country Reports and workshops is that private equity investors will have difficulties exiting their investments. A major research report entitled *Latin American Private Equity Review & Outlook 2000/2001* also emphasizes this concern:

“[w]hile there have been a handful of splashy exits, and several lower-key divestments, that hint at the region’s potential, investors understandably question why there have not been more exits, given the number of deals closed and the favorable trends in both foreign direct investments and M&A [mergers and acquisitions] activity.”²³

Many practitioners and observers consider exit problems perhaps the single most pressing issue regarding risk capital investment in Latin America. The principal reason is that, in the next couple of years, a large number of private equity funds will be attempting to exit their investments. The success of such efforts will have a direct bearing on future fundraising efforts for funds dedicated to the region.

Traditionally risk capital investors rely on three possible exit alternatives: IPOs, trade sales and exercise of put options. Each of these exit alternatives has different rights associated with it. Most private equity investors seek to exit their investments in no more than seven years and most prefer three to five year exits. Thus, legally enforceable exit mechanisms are critical for the future of private equity flows into Latin America. As the first wave of private equity funds seek to exit their investments within this time frame, if there are widespread enforcement problems related to contracted exit mechanisms, this will inevitably have a serious negative effect on future private equity fund raising initiatives. As one fund manager has stated:

“The jury is still out with respect to the institutional investors, as to whether this is a good thing or a bad thing, and they all put in a little bit of money in to see what’s going to happen. Until we collectively provide them with returns and they have a benchmark to assess it against, it’s hard to say whether they are going to step up for a second time or not.”²⁴

Investment funds structure their investments with a variety of exit rights designed to provide alternatives. An early stage investment may contain demand registration rights, a drag-along right and a put. If over time an IPO exit is not viable, then a trade sale may be considered; failing that, the investment fund can exercise a put. A later-stage investment can be structured with a redemption feature so that the exit is assured by a company obligation and also have conversion rights whereby the preferred equity purchased can be converted into common stock which in turn has demand registration rights. Whatever structure is chosen, a key consideration is to ensure that at least some mechanism exists at the outset to sell the investment within the intended investment timeframe.

The perceived problem of enforceability of exit mechanisms is multidimensional. At the broadest level, the same problems common to the judicial systems of Latin America apply to enforcement of sophisticated international commercial contracts everywhere. Investors are concerned with the potential for inconsistency, lack of transparency, unpredictability and delays for any final resolution of commercial conflicts in the judicial systems of all of the countries.

²³ Holly Johnson and Robert Pease, eds., *Latin American Private Equity Review and Outlook* (Wellesley: Asset Alternatives Inc., 2000), p.57.

²⁴ “A Private Affair,” *Latin Finance* (December 1998): 61.

There are problems, however, that are more specific to some of the mechanisms themselves. One is lack of familiarity with the contractual rights commonly used in deal documentation for foreign risk capital investments. There is no statutory prohibition in the countries surveyed, for example, against tag-along or drag-along rights, put options or registration rights. The lack of familiarity with these provisions, however, makes them subject to uncertainties in interpretation by local judges. Furthermore, courts in Latin America are far less inclined to grant specific performance as a remedy. And in the context of an investor that wants out, suing for damages is generally a poor substitute for specific performance. For example, a minority investor that litigates to enforce a drag-along right (assuming the absence of self-executing mechanism such as a trust or an off-shore holding vehicle) is unlikely to be able to keep the buyer interested while litigation is ongoing. Furthermore, the individuals or entities against whom judgment may be directed may not have the means to pay, and executing against their properties may be yet another uphill courtroom battle.

Litigation, of course, does not add value to investments and almost invariably is symptomatic of either a failed or significantly underperforming investment or serious misalignment of interests between the private equity fund and other shareholders. Furthermore, it can disrupt the investment horizon of a fund and its investors by pushing out the time frame beyond that normally set at a fund's inception. As mentioned above, note that funds usually have a two to three year investment period, which added to the time period when exit is most likely to occur means problems can arise in the seventh or eighth year of an investment's life. Litigation in all of the countries studied can easily take more than two or three years in court to reach a decision and more time afterwards in enforcement actions—, thereby giving rise to the situation of a fund's life being extended beyond the intention of its investors.

Problematic exit mechanisms create distortions. A fund manager that gets thwarted on an exit attempt as a minority investor or learns of others who have, may forsake minority positions and only invest in controlling interests. Thus, small companies that are not willing to surrender immediate control lose the opportunity of a potential minority equity investor. Furthermore, since having a controlling stake means that the fund manager is directly or indirectly running a company, it entails a greater commitment of time and resources from the fund manager. Again, the smaller companies lose out because the deal size may not justify the additional commitment.

A. IPOs.

There are two principal exit rights related to IPOs: (1) so called "piggy back rights," and (2) demand registration rights. Under the former, a company is legally bound to include the shares of an investor in the event of a public stock offering. Demand registration rights require a company to register investor's shares if a company goes public, and depending on how they are negotiated, allow risk capital investors to force a company to try to go public. Neither demand registration rights nor piggy back rights are addressed specifically by statute in Argentina, Chile, Brazil, Mexico or El Salvador. Unlike problems associated with preemptive rights, buy-back of shares, and issuance of warrants, all of which confront specific statutory obstacles, in the absence of any statutory underpinning, these exit rights may be drafted into agreements only to later be deemed unenforceable or subject to adverse interpretation.

If a dispute arises out of an IPO exit, it is more likely to be because the fund manager wants the company to go public and the other shareholders do not.²⁵ This situation can arise when the original shareholders refuse to surrender control over a company or believe that there are more financial rewards in a company remaining privately held. Faced with shareholders that refuse to take the company public, the fund manager then has to decide whether or not to pursue legal action. It is at the point where there are two opposing views that "enforceability" becomes an issue.

Regardless of potential problems with the enforceability of exit rights associated with IPOs, market conditions are currently highly unfavorable for such exits. Practitioners in the surveyed countries agree that the IPO exit is not readily available in Latin America.²⁶ Local capital markets difficulties, such as lack of or severely

²⁵ Usually, fund managers are more attuned than the companies themselves to the possibilities of an IPO exit, because they are experienced in the process and more knowledgeable about market conditions.

²⁶ "A Private Affair," *Latin Finance* (December 1998): 61.

restricted liquidity, will have to be overcome in the near future in order for local IPOs to be a viable exit option for risk capital investors.

The current absence of a viable IPO exit through local stock exchanges has a disproportionately negative impact on SMEs. One observer states: "The reliance on trade sales has meant that the better-capitalized funds that generally made larger investments in larger companies have come out ahead of nimbler funds which looked for smaller, riskier investments."²⁷ In short fund managers evaluate companies for their potential future strategic value for strategic buyers, which means focusing on a narrower list of companies at the expense of SMEs. Thus, strengthening local stock exchanges remains a key component in the medium and long run to risk capital growth for SMEs.

B. Trade Sales.

In a trade sale, sometimes also referred to as a strategic sale, a private equity backed company is sold to another company. The buyer is usually a larger company seeking the market share or product lines of the target company. Because of the problems with IPOs exits, practitioners in all countries surveyed believe that trade sales will be the principal exit mechanism for successful investments in Latin America in the near and medium term.²⁸ The *Latin American Private Equity Review & Outlook* substantiates this conclusion by reporting that thirteen out of fifteen recorded exits in the region have been through this route. Further evidence is found in a 1999 Pricewaterhouse Coopers survey, in which "sixty eight percent of the respondents say they sold their holdings to a strategic buyer, while only 5% took the IPO route, either domestically or internationally."²⁹ There are two principal legal mechanisms associated with trade sales, so called "tag-along" and "drag-along" rights. In the former, an investor has the contractual right to join another shareholder when such shareholder is selling its shares. In the latter an investor can force another shareholder to sell when it is selling shares. While tag-alongs are of importance to the fund primarily as a defensive mechanism—that is, so the fund is not left with an investments while the original shareholders are exiting, the drag-along is of a more critical nature to the initially envisioned exit. A fund in making an investment may evaluate the target as a trade sale candidate, particularly if an IPO seems unlikely. If in fact a trade sale is preferred by a fund and remaining shareholders object to the enforceability of the negotiated drag-along rights it becomes critical.

C. Put Options.

Put options are contractual rights that enable the holder of the option to sell its shares to another party at an agreed price, usually determined by a formula. Put options are not ordinarily the preferred exit mechanism for risk capital investors because trade sales or IPOs generally yield better prices for the risk capital investors. Put options, however, often play critical role for minority investors as a last line of defense against illiquidity. With a fund's term coming to an end and no IPO or trade sale in sight, a put option may be the only exit available to the risk capital investor. Problems with the enforcement of the put can therefore create problems for the fund manager whose contractual arrangement with its investors is to exit investments within an established time period.

²⁷ Mark Piper, "Waiting for a Way Out," *Latin Finance* (November 2000):40.

²⁸ Trade Sales are the main exit route in Europe. See "Venture Capital in OECD Countries," *Organization for Economic Cooperation and Development* No. 63 (February 1996):15.

²⁹ As reported in Onelia Collazo, "Private Equity Alive and Well in Latin America," *Latin Finance* (March 1999):12

V. POTENTIAL APPROACHES TO OVERCOME EXISTING PROBLEM AREAS

In this Section V we describe various approaches that governments in the countries studied may choose to overcome the problem areas we have identified as barriers to risk capital investors in their respective countries. Irrespective of the particular combination of approaches, in order for such an effort to work effectively, solutions to the problems will need to be comprehensive, addressing corporate and tax laws, regulations and agency practices. We present four potential courses of action: (1) revising existing laws, (2) passing new legislation and corresponding specifications and contractual rights, (3) expediting the judicial process, and (4) establishing specialized administrative agencies.

A. Revisions to Existing Laws.

Many of the problem areas identified in this report can be overcome by amendments to the current corporate laws of the five countries analyzed. As an example, last year Chile adopted amendments to its corporate and securities laws that address some of the problem areas discussed in this report. These amendments known as the Ley de Opas were principally the byproduct of controversies regarding tender offers to the perceived detriment of minority shareholders, but covered other areas as well. The Ley de Opas applies specifically only to public companies, but other companies may voluntarily submit to its application. Private equity funds may consider making this submission a requirement with respect to the companies they invest in.

The Ley de Opas now expressly allows for stock option plans, albeit with some restrictions, and it permits buy-back of shares by companies on a restricted basis. With respect to corporate governance, the Ley de Opas took some positive steps such as providing for audit committees and requiring shareholders meetings for certain actions at the request of minority holders coupled with mandatory votes of directors. Furthermore, the Ley de Opas tightened definitions of “self dealing” among related entities. The Ley de Opas is a good example of how amendments to existing laws can address some of the problem areas identified in this report.

B. Adoption of New Laws.

Some problem areas require completely new laws. New trust legislation in some countries could alleviate some of the enforceability problems. Some of the governments could follow the example of other countries in passing legislation governing investment funds. As an example, Spain in 1999 enacted a venture capital law that not only set up the regulatory structure under Spain’s Security Commission but also made critical amendments to the tax laws that were key to stimulate activity in the industry. Also, Argentina passed regulations aimed at strengthening the competitiveness of its SMEs by creating new funds and restructuring existing ones. These regulations create a “Development Fund for Small and Medium Enterprises (‘Fonapyme’)” which will provide financing for the SMEs³⁰ and a “Guarantee Fund for Small and Medium Enterprises (‘Fogapyme’)” which will provide additional guarantees to SMEs.³¹

C. Codification of Contractual Rights.

A fundamental difference between civil law and common law regimes is that the former has more specific statutory provisions governing a wide range of contracts and contractual matters. By training, the first place civil lawyers and judges turn to for guidance in contractual matters are statutory provisions and treatises. This means that in practice many items that do not have a statutory footing have a built-in potential for misinterpretation. This also means that in order to facilitate and create incentives for risk capital investment many revisions could be made to the commercial codes of the Latin American countries examined in order to specifically acknowledge the existence of mechanisms common to risk capital transactions. One potential approach that could diminish the possibility of misinterpretation of exit rights would be to “codify” them by statutory dispositions. A statutory

³⁰ An Investment Committee will be formed to set the investment policies of Fonapyme and to ensure equitable distribution of its resources.

³¹ In addition to those granted by the Reciprocity Guarantee Corporations (created by Law No. 24.467 to facilitate the access to financing for SMEs) and to grant direct guarantees to financing institutions which are creditors of SMEs to facilitate lines of credits.

provision could, for example, define “drag-along” as the right of the beneficiary to force the bound party to sell its shares to a third party and expressly provide that “drag-alongs” are valid and enforceable. Revisions to commercial codes could also expressly permit private parties to craft the drag-along as to such important features as the circumstances under which it may be exercised.

The delineation of exit rights in statutory form may have benefits beyond enforcement issues. A common concern raised by fund managers is a lack of understanding among companies as to how risk capital investments are structured. Having exit rights in statutory form provides a foundation through which the investment structures can be understood. As an article in *Euromoney* points out, a frustrating factor in term sheet negotiations is the unfamiliarity of companies with typical venture capital terms. But even where familiarity exists, parties must confirm that their definitions are consistent to avoid disagreements and disappointments later. This is particularly true where the investors and the company come from different cultures with different business practices and legal systems.³²

Codifying exit rights would not solve all exit problems described above. Even with clear statutory provisions litigation could be sought by shareholders subject to the exercise of such rights. Codifying should, however, eliminate the argument that some or all of the exit rights are unenforceable, which can lead to extreme positions in negotiations concerning exits.

D. Expedited Judicial Process.

As discussed above, certain exit rights are time-sensitive. All counties surveyed have expedited proceedings for some types of actions such as for demanding payment under promissory notes. One answer to facilitate the enforcement of exit rights is to provide for an expedited judicial proceeding when a dispute arises out of the exercise of “exit rights.” The combination of “codification” of exits rights and an expedited judicial proceeding can lead to quicker and more certain outcomes. The solution of exit-related disputes in a timely fashion can also strengthen confidence levels risk capital investors analyzing worst case scenarios at the time of contemplating new investments.

E. Specialized Administrative Agencies.

An alternative to court resolution of some shareholders’ disputes is to have such disputes handled by a specialized division of an administrative agency. By “specialized” in the context of this report we mean that agency personnel would be trained to know the nature of risk capital investment and the related legal structures. Taking these matters out of the province of the courts would be no more drastic than the by now fairly universal approach of accepting private arbitration as an alternative means of dispute resolution. This model has been suggested by one scholar with respect to certain corporate governance issues in Eastern Europe, who states “a practical approach to effective enforcement may lie in creating a cadre of administrative judges within an U.S. Securities and Exchange Commission-like agency, authorized to broadly enforce both disclosure obligations and certain rules against self-dealing...”³³

The expedited judicial proceeding and specialized administrative agency models are not meant to be a substitute for arbitration proceedings. An important difference between a “Special Administrative Decision Model” and private arbitration is that the administrative agency could have enforcement mechanisms that are not directly available in private arbitration and that could prove crucial to rendering effective remedies. The idea is to have a wide range of options for investors and companies to structure their relationships. Thus, parties may wish to have some more technical matters subject to arbitration (e.g., valuations under agreed formulas) while carving out from the arbitration provisions other matters such as enforcement of some exit rights which can be handled by an expedited judicial proceedings or through a specialized administrative agency.

From the standpoint of better decision making, the specialized administrative agency model has two distinct

³² “Venture capital in Latin America” *Corporate Finance* (September 2000): 3.

³³ John C. Coffee, Jr., “Privatization and Corporate Governance: The Lessons from Securities Market Failure,” *The Journal of Corporation Law*, 25 Iowa J. Corp. L. 1, p. 28.

advantages to the courts. First, one significant problem of the courts is the lack of familiarity of judges with the contractual rights associated with risk capital investing. A properly trained administrative judge would not have such problem. Second, the agency would have a policy interest in ensuring a level playing field. Much as security regulators are driven by policy concerns of ensuring the integrity of the market, administrative judges would be more attuned to the importance of risk capital to their respective country's needs, which in the absence of other factors would lessen the possibility of inconsistent determinations due to non-legal factors. Properly implemented, the specialized administrative agency model would also save time. Processes could be set up to produce determinations under short timetables, which is hard to do even under expedited mechanisms under the court system.

VI. CONCLUSION.

Throughout this report we have identified areas in which the effects of current legal frameworks on risk capital disproportionately impacts SMEs. In Section III, for example, we noted the importance of stock option plans and how their unavailability under local laws have lead to the use of offshore vehicles which may be too costly for SMEs. We have also noted that prohibitions against buying back shares, all other things being equal, affect SMEs more because in many instances this may be the only viable exit mechanism.

Despite the great strides made over the last decade by the governments of the countries studied to attract foreign investment and provide local capital to SMEs, there is room for improvement in order to facilitate risk capital investment. The Country Reports, workshops and interviews indicate that there is a pressing need for legal and regulatory change to address problem areas for risk capital investment in all five countries—and presumably elsewhere in Latin America. As stated by the Latin America Private Equity Review & Outlook “in order for the Latin America private equity to grow and eventually flourish, a significant amount of legal and regulatory changes will need to be implemented.”³⁴

We have seen how all stages of a potential risk capital investment can be adversely affected either by local corporate laws themselves or the threat of their non-enforcement. At the due diligence stage, investors face problems with local accounting practices and evaluating contingent liabilities. At the structuring stage, local laws do not comprise the array of capital structures needed to provide investors and their local partners with the necessary flexibility. The absence of stock option plans, problems with redemption of shares, and difficulty in issuing warrants are some of the roadblocks to efficient structuring attributable to deficiencies in the local laws. Once investments are realized, investors who take minority positions have a hard time getting their rights protected and those who are majority holders may be unable to enforce agreed upon tag-along or drag-along provisions. Finally, and perhaps most importantly, risk capital investors need greater certainty with respect to the enforceability of exit rights.

Limitations in legal regimes do not favor the local economy, local partners or risk capital investors. They simply raise the risk profile for investors, which often translates into lower valuations. In some cases, the perceived risk may tip the balance against making an investment sought by the local partners. If the impediment can be bypassed through legal and financial engineering, it adds significant transaction costs to neither of the parties benefit. In short, unlike, for example, lending laws that can be viewed as potentially favoring borrowers or lenders, the existing statutory limitations identified in this report generally do not favor local companies over fund managers, or vice versa. These limitations are negative to both.

³⁴ Holly Johnson and Robert Pease, eds., *Latin American Private Equity Review and Outlook* (Wellesley: Asset Alternatives Inc., 2000), p.75.

Annex I: Summary of Legal and Regulatory Problem Areas with respect to Risk Capital Investments in Small and Medium Size Enterprises

√√√ = Significant Widespread Problem

√√ = Important Problem

√ = Problem in Some Cases

<u>Problem Areas</u>	<u>Degree</u>
Contingent liabilities such as back due taxes, social security contributions and environmental liabilities	√√√
Unclear or no investment fund legislation	√√√
Restrictive investment fund legislation works against attracting risk capital investment at the local level	√√√
Absence of effective minority shareholder protection	√√√
Limitations on possible investment structures	√√√
Lack of stock option plans forces companies to set up offshore companies, thus increasing transaction costs	√√√
Restrictive regulation of local stock exchanges, whereby IPOs on local stock exchanges are not a viable exit strategy	√√√
No waiver of redemption rights limit the effectiveness of put options	√√√
Restrictions of foreign ownership in certain sectors detract foreign investors	√√√
Inconsistent tax treatment and limited effect of tax audits	√√√