Published by *WorldTrade Executive, a part of Thomson Reuters*

LATIN AMERICAN
Law & Business Report

Volume 19, Number 11 — November 2011

HIGHLIGHTS

Roundtable Discussion on VC Opportunities in Brazil, Colombia and Region

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LATIN AMERICAN LAW AND BUSINESS REPORT
(ISSN 1065-7428) is published monthly by WorldTrade Executive, a part of Thomson Reuters, 2250 Main St., Suite 100, P.O. Box 761. Concord, MA 01742 USA. *Tel:* (978)287-0301 *Fax:* (978) 287-0302
Internet Home Page: http://www.wtexecutive.com

VC Opportunities in Brazil, Colombia and Beyond:
An Exclusive Roundtable Discussion with FIU, Intel Capital, Flybridge and Tres Mares

Interview Conducted by Alyson Sheehan (Thomson Reuters)

Florida International University in Miami hosted second annual Americas Venture Capital Conference featuring nineteen hand-picked startups from Latin America and South Florida in November. Four attendees of the Conference recently spoke to LALBR in a roundtable discussion:

Irma Becerra-Fernandez*: Founder and Co-Chair of the Americas Venture Capital Conference and Vice Provost for Academic Affairs at Florida International University*
Faquiry Diaz Cala*: President and CEO, Tres Mares Group*
Jon Karlen: *General Partner, Flybridge Capital Partners*
David E. Thomas*: Managing Director, Intel Capital*

Opportunity in Cloud-based Businesses

LALBR: What are U.S. venture capitalists encountering as they aim to source their first deals in Latin America?

Irma: Many venture capitalists made their first investments in Latin America within the past three years and are now looking to make other investments, which is really heartening. What is also really encouraging is the involvement of service providers, like Silicon Valley law firms, who are significant players in this field as well.

Jon: The first thing we encounter is abundant opportunity, driven by the trends surrounding the rising middle class and the development of robust domestic consumer markets in Latin America, particularly in Brazil. In addition, the local VC markets are maturing. For example, in Brazil there are a number of strong local VC firms, with whom you can partner, that help provide some of the local support, oversight and value-added that you'd be looking for. These are real positives.

Businesses have moved not just to being online but to being truly web-based, or cloud-based, businesses; they've moved to being virtual and capable of entering 15 or 16 countries across Latin America at once, which provides huge scale advantages.

On the negative side, there are challenges to being an early-stage investor. We invest in start-ups, which are very high-risk ventures that are trying to invent the future. Because we're based in Boston, we can't work with the local teams as closely as we'd like. So that is one challenge – what the distance presents. The second challenge is local regulations, restrictions and tax regimes. Regulatory issues are probably the single biggest hurdle that we confront both at the time of investment and on an ongoing basis with our portfolio companies, as they continue to try to scale and build their businesses.

David: I'm based in Sao Paulo and manage Intel Capital's activities in Latin America. We've been investing in the region since 1999. We're seeing a number of U.S.-based venture firms exploring opportunities in Brazil, and a number of them have been getting their feet wet on their first deal within the last 18-24 months.

Faquiry: We have invested in Mexico, Chile and Peru, mostly in private equity deals over the last twenty years. As we do deals that are more VC-oriented in Latin America, we are seeing more crossover deals. We're seeing some pan-regional companies that are expanding from the get-go, which is very interesting from a VC point of view. Entrepreneurs are not just growing a company in one country and helping it scale country-by-country,

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but rather, they are taking a pan-regional approach from day one.

Jon: All these businesses have moved not just to being online but to being truly web-based, or cloud-based, businesses; they've moved to being virtual and capable of entering 15 or 16 countries across Latin America at once, which provides huge scale advantages.

Irma: A lot of VCs are keeping in mind the potential that these investments will be palatable to the Hispanic market here in the U.S., which is another reason why investments in Latin American are considered attractive.

Entrepreneurial Ecosystem, 'Me Too' Phenomenon

LALBR: How does Latin America's entrepreneurial ecosystem and deal pipeline compare to other emerging markets?

Irma: It's heavily focused on IT, social media and enterprises that resemble North American successes, nicknamed "Me too's". One example of this is MercadoLibre, which is an e-commerce site considered a "Me too" for eBay.

Jon: The ecosystem is just very small. In general, the single biggest constraint is the pool of world-class entrepreneurs, not the ideas. The hiring is difficult, and particularly with start-ups, there is a higher level of risk aversion. Therefore, talented executives really value the name brand, the blue chip company, and are less likely to try their luck with a start-up. So those are three considerations: the ecosystem is small; there's a bit of risk aversion; and it is difficult to hire.

David: When you look at Latin America, you have to look at each country a bit differently. Brazil is unique in terms of the types of deals you would see, the quality of the entrepreneurs, the quality of the management teams, the capital markets' reform that has taken place, and the market for liquidity. All these things have changed substantially over the last 5 to 7 years. When you look beyond Brazil, the investment environments are more mixed. We have had success investing in Chile, where the market is very well-established and stable, but we don't find as much entrepreneurial activity in the tech sector in some of the other smaller Latin countries.

For example, in Mexico and Argentina, we have found good developers, but we haven't seen a significant number of entrepreneurs looking to create companies to go pan-regional. We haven't seen as much of that activity outside Brazil. I would also echo the comment that there exists a "Me Too" phenomenon. We've seen a number of deals in the consumer internet space that are duplicating models that have worked well in other markets. In the last five years or so, particularly in Brazil, we've seen a much broader opportunity set; we're looking at deals in healthcare, digital signage, software and services. So, a much broader pipeline has developed, which is a real positive in terms of looking ahead.

Faquiry: What we're seeing is a very interesting group of Web 1.0 entrepreneurs from the '90's returning to the region for new deals as investors. They are investors who are comfortable with technology, who understand scalability, and who understand that we're now in a kind of "lean" model world. These investors are able to convince some of the Latin American entrepreneurs who may have been tentative to go off on their own, to go for it, because they themselves experienced it a decade ago and are backing the new startups.

It's heavily focused on IT, social media and enterprises that resemble North American successes, nicknamed "Me too's". One example of this is MercadoLibre, which is an e-commerce site considered a "Me too" for eBay.

LALBR: What do you see as the most important sectors for venture capital investment in Latin America? The most oversaturated sectors?

Faquiry: The most saturated areas of investment, tome, are those having to do with Brazil. Yes, there are great things coming out of Brazil, but when there is more money chasing deals than there are deals to be made, you have oversaturation. On the positive side, I think there are good deals being made in Latin America in the mobile space and in social media, same as in the U.S, which is very exciting.

Irma: Other growth sectors in Latin America similar to those in the U.S. are energy and pharmaceuticals. But I would still say that most of the development is concentrated around "Me too's," which is an area that is a bit saturated. Latin American entrepreneurs need to see more billion dollar IPOs. I think that would really set the tone for further entrepreneurship.

Jon: The most important categories from an early stage venture capitalist's perspective are consumer-driven businesses in Latin America. Investment is all fundamentally driven by the explosion of internet broadband penetration, the rising middle class, and the intersection of where these consumer trends meet the web and mobile. And yes, the most overheated sectors are these "business model imports", where you have entrepreneurs taking proven models from the U.S. and elsewhere and importing them to Latin America, because it's the easiest venture for people to get their heads around.

David: We're seeing a lot of activity in the consumer/internet space as far as Brazil and Latin America in general is concerned, but it's hard for me to make a broad statement that IT is oversaturated. Brazil is now the third largest PC market in the world; we will likely sell more PCs in Colombia in the next 3-4 years than we have in the last thirty. Beyond consumer internet, with rising discretionary income there is a lot of growth happening in consumer-driver sectors, so that's where I would say it's most oversaturated. Also, from what I've seen and read, there appears to be a lot of investment in alternative energy sources in Brazil as well, and my guess is that area is probably a bit saturated as well.

LALBR: What's the next biggest destination, country-wise, for the Latin American venture capital deals?
Irma: Brazil is probably the biggest destination, currently. In terms of what the next market to watch will be, Chile appears to be trying to position itself as the next big player, with the government's Startup Chile program. But we also see significant development coming from Argentina, Colombia and Mexico, so these are also countries to watch.
Faquiry: As much as Chile would like to consider itself the next big one, Colombia is a very strong up-and-comer. Colombia's demographics are there; the local VC community is a bit further behind than in other places; President Santos has made a few initiatives, which provide quite a bit of support to the local companies; and the local universities are beginning to build their community, so I think we will be seeing some really interesting things coming out of Colombia.
David: I would echo that: Colombia is really the gem. They have critical mass; they have an educated population; they have only had three years of negative growth in the last 100 years – it's a very stable country. The government has taken a lot of strides in terms of reducing crime over the last 10 years, so it's much safer than it's ever been.

Beyond Colombia, I think another interesting country, although smaller, is Peru. Peru is relatively stable. It has witnessed incredible growth in 2010, and GDP growth has averaged almost10 percent over the last several years. So, I think that's another country that people should watch.

Jon: I would say Colombia.

Increased Allocations in Emerging Markets

LALBR: What factors have allowed Latin American startups to ultimately achieve a successful exit?
Jon: I would say that it's all about category leadership. If you're the number one category leader in an important category, such as e-commerce or mobile, you're interesting not only to the local incumbents but to the international leaders, who view the business is as a natural entry point into the expanding emerging market in Latin America. Clearly there are IPO possibilities as well, but recognizing that most exits end up in M&A, I think that being a category leader could attract a somewhat silly or irrational price as opposed to a highly logical and rational price from a domestic incumbent.
Irma: If companies have access to good coaching and access to American financial networks, that's probably a good predictor for a successful exit.
David: We've been fortunate enough in our portfolio to have a successful exit every year at least for the last 5 years. Those exits are either category leaders that catch the eye of a global investor, as Jon mentioned, or they are a pan-regional play. For example, we had a portfolio company go public in Chile whose strategy was to expand across the region. That worked out well; they were able to go public after they diversified their revenues from a mainly Chilean base to a regional base. As far as the capital markets and getting liquidity, we have seen significant public market activity in Brazil, thanks in part to some positive governance changes. This helps create the perspective for companies of: "Hey, I can get there. I can get public. The system is starting to work."

We're seeing some point-of-sale terminals, back office payment systems, and core banking software companies that are Brazilian-based with a very large market to capture. They are unique to Brazil!

Longer Investment Horizons

LALBR: In today's heated environment for early stage investing, what types of ventures will evolve into sustainable businesses?
Irma: Companies that provide solutions to traditional barriers of entry are the ones that will have more sustainable success in Latin America. For example, there are certain things that we take for granted here in the U.S., like the fact that you can order anything and it'll be delivered to your door the next day, because we have a quite developed infrastructure for the delivery of any product. This simple assumption becomes a bit of a challenge in Latin America, depending on where you are. The extent to which a company can figure out those specific barriers relevant to their country and then resolve those barriers is a way for a company to distinguish itself from its competitors and create sustainability.

LALBR: Are there indigenous technologies unique to Brazil?
Faquiry: We're seeing some point-of-sale terminals, back office payment systems, and core banking software com-

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panies that are Brazilian-based with a very large market to capture. They are unique to Brazil! The question becomes: can they scale outside Brazil and go forward? I'm not sure. The Brazilian market is so large that some Brazilian entrepreneurs today have decided that they can make a company big enough there; that the good times will roll in Brazil until the Olympics, and that by then, they will exit. As far as I can tell, the venture-backed companies are not as focused on expanding outside Brazil yet.

David: I think that's accurate. Domestic consumption in Brazil is so large that most of the tech companies we see are targeting that market. We do see entrepreneurs with big plans to go global, but I have not seen one execute successfully on that, to date from Brazil. From our perspective, at least today, there seems to be enough room in Brazil to get to a size where an investment makes sense from an IRR standpoint. But from the perspective of an independent venture capitalist who wants to invest in companies to go global, I haven't seen a lot of examples of that – at least not to date.

Jon: The reality is that the world is getting pretty flat. We're not there yet, but Brazil and some of these other emerging markets are catching up to developed markets, and I would expect that over the next decade, some global leaders will emerge out of Brazil. There is a strong software market there, and there is some game development that is very strong as well. In many cases, the biggest opportunities for early stage venture capitalists are in areas where Brazil is still behind the U.S.

David: There are a couple areas, like banking and security, where there are some companies that are really unique. There are a couple pockets that could prove themselves. Brazil is also in a very good place in terms of oil exploration and deep sea drilling, and they're also leaders in terms of agriculture and farming methods. So I think those are also a couple areas in Brazil, agriculture and oil exploration, which are indigenous.

LALBR: What is your allocation between developed versus emerging markets?

Jon: We are a Boston-based venture firm that has done some international investing, and we are just developing our practice area in Latin America today. This is a very interesting market for us and we've made a few investments. We're going to continue to explore, and we're working hard at it.

David: Our allocations fluctuate over time. Ten years ago, we were doing about 5-10 percent of our activities outside of North America. Today, that allocation is anywhere from 35-50 percent. We are doing more and more in emerging markets.

Faquiry: We grew out of Latin America twenty years ago and are coming into the U.S. to do deals on the west coast, in Silicon Valley. We are also looking at the crossover market; that is a sector where we don't see a significant amount of focus from other investors. Here we think there is opportunity to do a U.S., Hispanic, and Latin American venture deal in one shot. This trifecta has lot of hidden value in our eyes.

LALBR: What are investors' expectations for performance and risk/return in Latin America relative to other emerging market opportunities?

David: We don't have anything set for Latin America versus other markets. I think we expect a longer investment horizon in Latin America. Where normally we would look at a five to seven year timeframe for a traditional fund, we probably expect a longer timeframe than that in Latin America, because windows open and close more frequently. That has been our experience, so that would be our expectation. Macro and political stability are also really important for us.

Faquiry: We are seeing a disconnect between the companies that are getting funded and the expectations that people have for them versus the public markets. For example, Brazilian public markets have not done very well in the last 12-18 months. Yet, the expectations of the companies that are being funded today over a five, seven year period is very high. I think we do have to question at one point whether the valuations have reached a level that discounts that eventual exit, and whether VC investors are paying exit multiples upon entering into the companies. What would happen if the exit windows found themselves being closed? You can have a longer time horizon, but you really cannot meaningfully afford to be around for ten to twelve years as an investor doing venture capital. ❏

VAT Planning For U.S. Companies Doing Business In Latin America:
Dealing with an Unexpected and Perhaps Unwelcomed Guest

By Leopoldo J Martinez and Carlos Contasti (LMN Consulting LLC)

Normally U.S. companies doing business in Latin America (LatAm) focus on planning around income tax or its withholdings, but an unexpected visitor must be considered: the Value Added Tax (VAT).

VAT is an indirect and non-accumulative tax that levies consumption of goods and services. It is imposed on the amount of value added at each stage of the production process or the supply chain, thus, an exporter of goods, a service provider or a technology company providing a license or collecting a royalty must work around VAT.

VAT is one of the most important revenue sources for LatAm governments. Therefore its compliance is strictly enforced. Accordingly, adequate VAT planning at the pre-business stage makes a difference.

Latin American countries differ from the European Union because there are no harmonized VAT rules and procedures. Each country has its own VAT system without any integration or collaboration between them. Moreover, some countries have a very complex indirect tax system, within the country. In Brazil, which is the largest economy in the region, the equivalent to VAT tax is disaggregated and distributed among its three territorial levels. Industrial products sales are taxed at the federal level (IPI); all other goods are the subject of state taxation (ICMS); and services are a matter of municipal taxation (ISS). In addition, there are significant differences in tax rates for ICMS and ISS among the cities and states. As a result, there is a regional and local war to tax transactions when the fiscal base is established in low rate state or city, but the customer is located in another place.

The lack of regional harmonization –amid the Brazilian nightmare of indirect taxation– also has created numerous problems when it comes to the importation of services. For instance, most of the LatAm countries would tax all services rendered within their territories regardless of the place of use or enjoyment, or the customer's location. In countries like Venezuela, all services rendered within its territory, and services rendered from abroad (imported services), when used or enjoyed in Venezuela, are subject to VAT. Argentinean Law takes the approach of establishing that services rendered and used or enjoyed abroad are exempted from VAT. The use and enjoyment of the service approach is certainly an undetermined concept, and there are many different interpretations.

Normally U.S. companies doing business in Latin America (LatAm) focus on planning around income tax or its withholdings, but an unexpected visitor must be considered: the Value Added Tax.

Normally, an exporter without an establishment or local presence deals with reverse VAT issues. Meaning that instead of collecting the tax from his client, the same is withheld by the client, who actually pays the tax. But other issues are relevant. In some jurisdictions it must be determined whether the transactions are a service or a royalty for intellectual property, in order to determine VAT exposure. Accordingly, contractually a license can be separated from related support services to optimize VAT exposure.

One key issue is VAT registration. In most LatAm jurisdictions it is prohibited that overseas companies register for VAT, unless they have some presence in the country, such as a permanent establishment. However, in most of the countries in LatAm when a foreign entity permanently or habitually supplies goods or renders services it will be mandatory to register for VAT purposes.

There are some benefits associated with VAT registration. The potential benefits are: (i) the right to recover tax credits arising from export activities, (ii) the ability to manage VAT withholdings, and (iii) the utilization of tax exemptions. Registration becomes particularly relevant when the company exporting services or goods into a VAT jurisdiction, for its commercialization or for support, is contracting with local

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providers charging VAT for their services, since VAT is estimated offsetting debits (VAT collected) with credits (VAT paid). Particularly relevant in LatAm –and here is a fundamental difference with the EU system– a non-domiciled company, one not registered for VAT purposes, can not file a refund of tax credit. Using this rationale, big companies tend to do business with registered companies with the objective of recovering the VAT output generated in the transactions. Also, most of the VAT regimes exempt businesses with sales below a threshold established by the law. Accordingly, VAT registration could be the basis of a VAT optimization strategy. When such decision is made, then a holistic approach to dealing with VAT and Income Taxation becomes necessary.

There are some countries in LatAm that have established certain VAT withholding methods, such as Argentina, Brazil, Colombia, Mexico and Venezuela. Withholding obligations could take place when the taxpayer sells goods or renders services to the Federal, State or Municipal government or decentralized agencies, or because the transactions are made with a "special taxpayer", normally a taxpayer with high revenues. VAT withholdings are not only a compliance problem; they represent a cash flow problem, because the final tax liability could result in a lower amount if there are VAT credits to offset the VAT debits.

VAT credits recovery is a practice in itself, whether from export activities, from inappropriate reverse VAT charges or from excess VAT paid as a result of a withholding imposed.

Finally, VAT compliance is an important issue to take into account. First, it represents an important cost. Second, non-compliance could trigger high penalties and business closures. Once more the lack of harmonization brings a complicated and entangled system. Commonly, compliance requirements such as bookkeeping, invoicing, records retention and return fillings are all treated in different ways, with some countries not accepting electronic invoicing (or requiring special approval for such practice). Electronic return filling has become popular in LatAm, but bookkeeping is especially entwined. In most of the countries there are books required by mercantile laws and specific books for VAT purposes.

VAT can certainly be an unexpected guest for U.S. companies doing business in Latin America. And without proper planning it can become a very unwelcomed guest.

VAT can certainly be an unexpected guest for U.S. companies doing business in Latin America. And without proper planning it can become a very unwelcomed guest. ❑

New Regulation of the Central Bank Affecting the Repatriation of Foreign Direct Investments:
What It Means for Foreign Investors

By María Fernanda Farall (Jones Day)

The Central Bank of Argentina (the "BCRA") has enacted a new regulation regarding the repatriation of foreign "direct" investments (i.e., the ownership of at least 10% of the stock/quotas/voting rights in an Argentine entity, as well as the ownership of real estate).[1] This regulation applies to certain direct investments made on or after October 28, 2011 (the "Effective Date").

Before the enactment of this regulation, foreign direct investors were free to purchase foreign currency in the Argentine official foreign exchange market for purpose of repatriating their direct investment (e.g., proceeds from return of capital contributions/capital reductions, sale of 10% or more of the stock of an Argentine entity, or sale of real estate) without the prior approval of the BCRA after 365 days from the time the investment was made.[2] The new regulation now also requires the foreign investor repatriating its foreign direct investment to show that the funds used to make the direct investment were brought into Argentina and exchanged into Argentine Pesos through the official foreign exchange market at the time the investment was made.[3] Otherwise, the foreign investor must obtain the prior approval of the Central Bank to purchase foreign currency for purpose of repatriating its direct investment.[4]

What does this new regulation mean in practice for foreign investors? While the regulation leaves several questions unanswered, here are the main takeaways.

The Regulation Applies to Certain Direct Investments Made On or After the Effective Date

Subject to the exception described below applicable to the transfer of direct investments between foreign investors, the regulation applies to direct investments made on or after the Effective Date.[5] The investment is deemed made when the funds are actually disbursed.

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For instance, if a foreign investor agreed to purchase real estate in June 2011 but closed on the sale in November 2011, such real estate investment would be subject to the new regulation because the funds for the purchase price would have been disbursed after the Effective Date. Consequently, when the foreign investor subsequently sells the real estate any time after the expiration of the mandatory 365-day waiting period (and assuming current foreign exchange regulations are in effect at the time of repatriation), it may purchase foreign currency for purpose of repatriating the sale proceeds without prior BCRA approval upon a showing that the funds used to pay the purchase price in November 2011 were brought into Argentina and exchanged into Argentine Pesos in the official foreign exchange market.

The Central Bank of Argentina (the "BCRA") has enacted a new regulation regarding the repatriation of foreign "direct" investments (i.e., the ownership of at least 10% of the stock/quotas/voting rights in an Argentine entity, as well as the ownership of real estate).

The Regulation Provides for Special Rules for Transfers of Direct Investments Between Foreign Investors

The new requirement does not apply to the repatriation of proceeds resulting from transfers of direct investments between foreign investors after the Effective Date if the transferor made the direct investment prior to the Effective Date.[6] If the transferor made the direct investment after the Effective Date, the foreign investor acquiring it would have to show in order to repatriate its investment freely that the transferor complied with the new requirement.[7]

For instance, if a foreign investor purchases real estate in December 2011 from another foreign investor who in turn acquired the real estate in October 2010, then the foreign investor making the 2011 real estate investment

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will have the right to repatriate the proceeds from a sale of the real estate any time after December 2012 without any restrictions (assuming current foreign exchange regulations are in effect at the time of repatriation). If, however, the foreign investor purchases the real estate in December 2012 from another foreign investor who acquired it in November 2011, the purchaser will have the right to repatriate the sale proceeds freely if it shows that the seller made the 2011 real estate investment by paying the purchase price using the local official foreign exchange market.

The Regulation Does Not Require that the Purchase Price for the Acquisition of Direct Investments Be Made in Local Currency in Argentina

Foreign investors acquiring a direct investment in Argentina after the Effective Date are not required under the new regulation to pay the purchase price in Argentine Pesos in Argentina. Nonetheless, the place of payment of the purchase price in M&A transactions or real estate investments has now become with the issuance of the new BCRA regulation more relevant for both purchasers and sellers.

From the purchaser's perspective, the payment of the purchase price outside of Argentina would mean in certain instances that the prior BCRA approval would be required for its investment repatriation, as explained in this article. From the seller's perspective, payment in Argentina would also create practical issues in certain circumstances. For instance, if the seller is an Argentine resident who wants to convert the proceeds into U.S. Dollars to invest them outside of Argentina, the seller would be subject to other foreign exchange regulations currently in effect in Argentina that restrict the acquisition of foreign currency up to US$2,000,000 per month as well as other recently implemented regulations imposing other restrictions on both Argentine individuals and legal entities.

Conclusion

Foreign investors considering investing in Argentina or disposing of their existing Argentine investments need to evaluate carefully the application and practical implications of this new BCRA regulation when structuring their investments or exit. ❑

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1 Comunicación "A" 5237 of the Banco Central de la República Argentina dated October 28, 2011.
2 Compliance with the mandatory waiting period remains in effect without any changes by the new regulation.
3 Section 1 of Comunicación "A" 5237.
4 Section 1 of Comunicación "A" 5237.
5 Section 1 of Comunicación "A" 5237.
6 Section 2 of Comunicación "A" 5237.
7 Section 2 of Comunicación "A" 5237.

Argentina November Tax Revenues Seen Up 31.4 pct yr/yr

By Reuters

Factors to Watch

Argentina's tax take is seen soaring again in November, driven by strong growth from income levies, social security takings and value added taxes (VAT).

According to the median forecast Argentina's tax take will be 47.82 billion pesos ($11.2 billion), up 31.4 percent year on year. Eight analysts were surveyed, with estimates ranging from 49.02 billion pesos to 47.55 billion pesos.

Analysts, though, pointed to weaker VAT income compared with the previous month as growth slows in Latin America's third biggest economy. Double-digit inflation is stoking consumer tax revenue.

Argentina's economy has been growing at one of the region's fastest rates on strong consumer demand, grains exports and industrial output, but the pace is expected to slow as demand falls in key markets like Brazil.

Rapid growth has helped the government maintain primary budget surpluses despite higher spending and was key to President Cristina Fernandez's landslide re-election victory last month.

"Tax revenue linked to economic activity (VAT and financial transactions) is slowing down but income tax collection keeps on growing, more than 40 percent. This is the tax with the highest rate of growth," said Guillermo Giussi of consulting firm Economia y Regiones.

Argentina, the world's No. 3 soybean exporter, taxes grain exports heavily, and income from grains levies will likely remain healthy while global commodities prices stay high.

Market Impact

Although a fast-rising tax take is positive for Argentina's creditors, state spending has been growing faster than revenue in recent months.

October's primary budget surplus shrank 85 percent from the same month a year earlier and the country registered a fiscal deficit of 2.98 billion pesos, compared with a deficit of 80.6 million pesos a year earlier. ❑

EU Reports on Potentially Trade Restrictive Measures in Argentina and Brazil

By Justin Miller and Staff (White & Case LLP)

On October 19, 2011, the European Commission's Directorate-General for Trade (DG Trade) published its eighth monitoring report on potentially trade restrictive measures that the European Union's principal trade partners,[1] among them Argentina and Brazil, have announced and/or implemented. The report focuses on new measures announced and/or implemented between October 2010 and September 2011.

The report notes that, between October 2010-September 2011, EU´s trading partners adopted 131 new trade restrictive measures while only 40 have been removed, totaling 424 measures since the start of the Commissions´s monitoring in October 2008. In addition, the report notes a tendency toward new industrialization policies based on subsidies and trade restrictions, which protect key domestic sectors from international competition. According to the EU, the strong economic recovery in many developing countries has not translated into a reversal of their respective trade restrictive measures. The report notes that Argentina leads the ranking of trade-restrictive countries (principally through import restrictions such as non-automatic import licenses and free-on-board (FOB) value reference prices). Likewise, in the same period, Brazil has joined Argentina in a tendency toward industrialization policies, which combine industrial support and trade-restrictive measures. During the reference period, Brazil introduced several measures ranging from duty increases and other border measures to a new 25 percent preference margin in the national law on government procurement. According to the report, Argentina and Brazil stand out on an individual basis both for the number and the type of measures introduced during the period of analysis.

We summarize below the most relevant conclusions of the report concerning Argentina´s and Brazil´s trade measures.

Industrial Policies

Several economies initiated comprehensive plans which mixed industrial policy measures (e.g., import substitution policies, local content and technology transfer requirements, and sector-specific financial support) with trade policy measures (e.g., border and/or behind-the-border trade measures) to spur industrial base growth, protect domestic companies from foreign competition and boost export performance. Most of these initiatives distort trade and competitiveness.

Argentina

Argentine authorities openly announced the implementation of the "import substitution policy" consisting of such measures as non-automatic import licenses for a wide range of products and the request that companies level import and export values (i.e., trade balancing requirements); and

Brazil

The recently enacted Bigger Brazil industrial plan targets the manufacturing, textile, footwear, furniture and software industries, among others, which will benefit from redistribution of revenues coming from export and tax exemptions. The report highlights Brazil's increase by 30 percent of the Tax on Industrial Products (IPI) for certain categories of motor vehicles with less than 65 percent local content (defined as that of Brazil, Mercosur or Mexico), which risks creating appreciable distortions for imported goods and could be deemed a breach of Brazil's WTO commitments. Furthermore, Brazil's steel industry could very soon benefit from a new export tax on iron ore, which would make ore cheaper to domestic producers.

Trade and Investment Measures

Border Barriers: Import and Export Restrictions

According to the report, border barriers (i.e., import and export restrictions) account for more than the half of total potentitally trade restrictive measures in force since October 2008 (238 measures out of 424 measures in force since October 2008).

Argentina

As in previous reports, Argentina remains the principal user of border restrictions targeting imports, accounting for 101 measures (out of 209 import restrictions in force since October 2008). Argentina has expanded the list of products subject to non-automatic import licenses, distorting trade and casting doubts in regard to the program's World Trade Organization (WTO)-consistency. In October 2011, more than 600 products (including automobiles, auto parts, motorcycles, bicycles, textile and some electronic products) were affected by Argentine non-automatic import licenses. In addition, Argentina continues to adopt new FOB value reference prices for certain imports, with 37 new instances in October 2010-September 2011; and

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Brazil

Brazil has accelerated its use of border measures through application of several import duty increases and import licences, such as those for imported cars and toys. It has reinstated tighter import procedures for textiles and clothing products and there are signals that such import controls may be applied to other sectors in the future. In addition, Brazil has further raised its import tariffs, independently of the Mercosur Common External Tariff (CET), which suggests that the current trend will continue in the near future.

Behind-the-Border Measures

Several Developing Countries have widely resorted to various types of behind-the-border measures as a way to shield local producers and further develop local industry based on technology and knowledge transfer. In September 2011, 103 behind-the-border measures remain in place, 14 more than in September 2010.

Argentina

Argentine officials are considering adopting a new "Buy National" law, which is likely to introduce the principle of discretionary powers in regard to strategic sectors, thereby serving the purpose of fostering industrialization by closing the market to competition from foreign providers. In addition, Argentina has adopted limitations to the cross-border provision of reinsurance services; and

Brazil

Brazil's temporary 'Buy Brazilian' law of July 2010, which set a 25 percent preference margin for domestic suppliers, was made permanent in December 2010. The preference margin was immediately applied to the ICT sector and is now being extended to cover other such sectors as health, communication and high-tech equipment following the enveiling of the Bigger Brazil plan on August 2, 2011. The Bigger Brazil plan introduces a set of measures aimed at fostering industrial development in several sectors. This plan contains measures that are likely to limit market access for foreign products and operators on one hand, and limit sectoral support schemes on the other. In regard to services, Brazil has targeted the reinsurance sector to limit the scope for cross-border cooperation between international companies within the sector.

Stimulus Packages and Export Subsidies

Given the size of fiscal stimulus afforded in 2008-09 during the period covered by the current report, the EU has not witnessed any major increase in support measures. However, certain countries continue disbursing funds in support of "strategic" sectors in order to build national industrial champions or to increase their exports.

Brazil

The Brazilian National Development Bank continues to support exporters through provision of low-cost credits, extending this program through 2014 in order to foster the growth of national industries as envisaged under the Bigger Brazil plan. Revenues from exports are expected to co-finance the program´s objectives of industralization, development of other sectors, and strengthening of the country's technological base. At the same time, corporate taxes are expected to fall for producers of automotive, textile, footwear, furniture and software products.

Trade Defense Instruments

In January-August 2011, 19 new investigations against EU products were initiated, a significant decrease as compared to the 36 new investigations initiated in the same period in 2010. However, the report notes that, after a rather moderate number of measures imposed in January-September 2010, there is an appreciable increase in the number of measures imposed in the first 8 months of 2011 (25 measures).

Outlook

Most analysts agree that trade restrictive policies and stimulus plans aimed at boosting key domestic sectors adopted since the outbreak of the economic and financial crisis are likely to remain in force in the near future. In regard to Argentina, on October 4, 2011 Argentine President Cristina Fernández de Kirchner officially announced Argentina´s "Industrial Strategic Plan 2020" (Plan Estratégico Industrial 2020 (ISP 2020)), which establishes investment, production and employment goals for the industrial sector in the period 2011-2020. Considering that the ISP 2020 aims to double domestic industrial production to reach USD 140 billion, most local sources indicate that Argentina is likely to continue adopting import substitution measures (principally low-cost loans to finance the purchase of capital and IT goods and import restrictive measures such as import licenses, trade balancing requirements, antidumping (AD) duties on imports and FOB reference prices on imports). With respect to Brazil, given the adoption of the Bigger Brazil plan to foster economic industrialization and diversification away from excessive reliance on raw material exports (e.g., oil), there are few signs that this trend toward restricting trade will reverse in the near-term. ❑

1 The report covers 30 of the EU's main trading partners, including: Algeria, Argentina, Australia, Belarus, Brazil, Canada, China, Ecuador, Egypt, Hong Kong, India, Indonesia, Japan, Kazakhstan, Malaysia, Mexico, Nigeria, Pakistan, Paraguay, Philippines, Russia, Saudi Arabia, South Africa, South Korea, Switzerland, Taiwan, Turkey, Ukraine, United States, and Vietnam.

Argentina and Brazil Coordinate Trade Policies to Reduce Imports from Third Countries

By Justin Miller and Staff (White & Case LLP)

On November 24, 2011, Brazilian Executive Secretary of the Ministry of Development, Industry and Foreign Trade (Ministério do Desenvolvimento, Indústria e Comércio Exterior (MDIC)) Alessandro Teixeira and Argentine Secretary of Industry and Trade Eduardo Bianchi met in Brazil to discuss the Brazil-Argentine trade relationship. The discussion centered on bilateral trade flows and coordinating actions to increase protection of domestic sensitive industries against imports originating from third countries (i.e., non-Mercosur countries).

Both sides reiterated their intention to facilitate the procedures in obtaining and approving their respective import licenses and in releasing products held at the border between both countries. In this regard, Secretaries Teixeira and Bianchi noted that the bilateral consultative mechanism created on June 2, 2011 proved to be effective and helped officials from both countries to assuage bilateral trade irritants. However, Argentine officials expressed their concern over Argentina's ever greater trade deficit with Brazil. According to figures of the National Institute of Statistics and Census (Instituto Nacional de Estadística y Censo (INDEC)) of Argentina, from January-October 2011, the Argentine trade deficit with Brazil increased by 45 percent, from USD 2.6 billion to USD 3.8 billion. Argentina's trade deficit is even higher according to official Brazilian statistics: MDIC reported that, from January-October 2011, imports into Argentina accounted for 8.9 percent of Brazil's total exports and resulted in a trade surplus of USD 4.9 for Brazil.

Also, Secretaries Bianchi and Teixeira agreed to continue ongoing work toward the integration of their respective domestic industries as an additional way to assuage bilateral trade irritants, enhance competitiveness of domestic industries and increase exports to third markets. Both countries are working on the integration of the following sectors: (i) oil and gas; (ii) auto parts; (iii) aeronautic; (iv) agricultural machinery; (v) wood and furniture; (vi) home appliances; (vii) wines; and (ix) dairy products.

Both delegations agreed that the financial crisis and economic recession in the United States and Europe could encourage China and other Asian exporting countries to divert their exports (particularly those of manufacturing products) to other countries such as Brazil and Argentina. In this regard, officials from both countries agreed on the necessity of adopting trade restrictive measures to protect sensitive domestic industries. The most likely measure to be adopted would be an increase of the Mercosur´s Common External Tariff (Arancel Externo Común del Mercosur (AEC)) applicable for certain products such as textiles and clothing, footwear, toys and peaches. Some of these products are currently subject to a temporary increase of the AEC which would expire at the end of this year. This decision will be adopted at the next Mercosur´s Common Market Council (Consejo de Mercado Común del Mercosur (CMC)) meeting that will be held in Montevideo, Uruguay, on December 19, 2011. However, press sources in the region indicate that both countries are also considering the adoption of further trade balancing and/or local content requirements. ❑

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Amortization of Premium on M&A Transactions and Current Status of Case Laws

By Roberta Perez Caneca and Carolina Ferraro
(Tauil & Chequer Advogados associated with Mayer Brown LLP)

Aimed at welcoming large amounts of investments in the "privatization" process of the Brazilian Telecom Public Company – TELEBRÁS - by offering advantageous conditions to the buyers and, therefore, obtaining better prices, the Federal Government enacted Law # 9,532/1997. It regulates the use of premium by expressly allowing its amortization to reduce the corporate income tax liability, provided that certain conditions are satisfied

In other words, the right to amortize the premium as provided for by the current regulation was originally designed as an incentive to private Brazilian investors to acquire companies resulted from spin-off of the Brazilian Telecom Public Company paying a price higher than the net equity value of such target companies.

Regulations require that the record of the premium in the investor books indicates the economic basis for the qualification of such premium which may be (i) the market value of company´s assets; (ii) the future profitability of the company; or (iii) goodwill (fundo de comércio), intangibles and other economic reasons. However, only the premium based on the future profitability of the target company is amortizable for corporate income tax purposes[1].

Therefore, in the event of a stock acquisition followed by an upstream or downstream merger, regulations[2] expressly allow the gradual recovery [through amortization] of the premium based on the future profitability of the investment. An appraisal study prepared by an independent professional at the time of the acquisition is advisable to justify the premium paid.

Although the right to amortize the premium based on future profitability is expressly authorized by the current regulations, tax authorities have challenged transactions lacking business purposes which appear to be implemented with the sole reason of reducing the tax liability by the use of the amortizable premium, especially when they are performed within the same economic group. Thus, following the international mainstream and supported by the so-called Brazilian anti-avoidance rule[3], tax authorities have applied the substance over form test in a way to avoid tax driven artificial transactions. The main controversies usually involve the existence of the premium, the evidence of its payment and the existence of sham or fraud to the law with respect to transactions that formally reflect a different reality.

The effects of the CARF decisions are limited to the parties involved on the respective cases. Nonetheless, it represents an important precedent and also shows that taxpayers can trust Brazil's institutions to protect their rights.

Even though there are reported decisions to the contrary, the Administrative Council of Fiscal Appeals ("CARF") has repeatedly stated that the right to amortize the premium should not be mitigated, unless tax authorities are capable of showing evidence of sham, fraud or the abusive use of the law. The regulations not only authorize so, but it also determines that the record is made in accordance with the premium economic basis.

In this sense, if the merger is actually performed and the existing premium is based on reports confirming the expected future profitability, as required by the regulations, the decisions issued by the CARF do not usually deny the amortization of the premium (Decision # 105-16.774 dated of 11.8.2007 and Decision 108-09.371 dated of 6.14.2007).

Recent Rulings by the Council

In October, 2011, the CARF signaled to taxpayers its intention to ensure legal rights against mistaken interpretations on tax provisions given by Brazilian Federal Revenue Office. In two very representative cases, the Council ruled in favour of the amortization of the premium generated in the context of "privatization" of Brazilian Telecom Public Company and the Bank of the State of São Paulo – BANESPA, also cancelling the

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aggravated penalty imposed for the events of sham or fraud to the law.

In one of the cases, a member of the CARF pointed out that the goodwill amortization and the corporate reorganization are authorized by the regulations and they were included in the package of conditions offered to the companies that participated in the "privatization" bids and, therefore, the tax planning could not be considered as abusive.

In the other case, the CARF found to be lawful the amortization of the premium transferred by a "conduit company" to the extent that the transaction (i) does not result in a lower taxation; (ii) the premium represents the expected profitability for the subsequent years; and (iii) the merger actually occurred.

The effects of the CARF decisions are limited to the parties involved on the respective cases. Nonetheless, it represents an important precedent and also shows that taxpayers can trust Brazil's institutions to protect their rights. ❑

1 IRPJ and CSLL

2 "a legal entity absorbs the assets and liabilities of another legal entity, by means of merger, consolidation or spin-off, in which it holds equity participation acquired with the payment of goodwill or discount computed in accordance with the article 20 of the Decree-Law # 1,598/77" (article 7º of the Law # 9,532/97 and article 385 of the Income Tax Rule – Decree 3,000/99) – free translation

3 "The Administrative authority may disregard juristic acts performed with the purpose to disguise taxable event or nature of components of tax liabilities, in respect to proceedings that will be provided in ordinary law." (Article 116 of the Brazilian Tax Code – sole paragraph) – free translation

The Brazilian Law On Homologation and Letters Rogatory

By Sergio Sardenberg and Francisco A. Fabiano Mendes

Brazil's recently inaugurated president Dilma Roussef, the first woman to be elected the country's highest official, has taken over the awesome task of leading the world's seventh largest economy, which has become a powerful magnet for traders and investors the world over.[1] Among the main reasons for that attraction is Brazil's expanding and diversified market of about 200 million inhabitants and its richness in natural resources, including enormous petroleum reserves that make it one of the world's major exporters of that basic commodity. Moreover, Brazil's thriving industrial sector is among the most modern and prosperous in the world.

It is also worthy of notice that the country's advanced constitution provides ample protection for individual and collective rights, thereby making Brazil a nation that is definitely under the "rule of law," a fact that has generated a great deal of interest in its laws, jurisprudence and institutions, among them those pertaining to homologation..

This article's purpose is to provide a basic description of the key features of Brazilian statutes pertaining to homologation, the process of internalizing foreign judgments, and letters-rogatory, a formal request from a court in which an action is pending to a foreign court to perform some judicial act. This article also discusses statutues that define the external jurisdiction of the Brazilian courts.

A basic reason for our choice of homologation as the main topic of the article was the fact that American and other foreign investors having interests in Brazil or desirous of establishing such ties often need to render enforceable a decision handed down by a court outside Brazil.

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Background

Brazilian law has traditionally followed the system of homologation of foreign judgments whereby extraterritorial decisions are given recognition and allowed to be enforced in the target country, provided that they meet a few basic requirements, which pertain to external aspects rather than to the merits of the judgments.

The Brazilian homologation system is one of the most liberal in a world panorama of great diversity of approaches. Swiss law, for example, takes the rather extreme position of altogether denying recognition to foreign decisions. Under the Anglo-American Common Law system, foreign decisions are generally given the

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limited value of constituting evidence, a new lawsuit being mandatory. In France and Belgium the legal system calls for a reexamination of foreign decisions, not only as to their formal aspects, but also as to the merits thereof.

Homologation is dealt with in the Brazilian Constitution[2], together with letters-rogatory, and in the Code of Civil Procedure (Law n° 5,869 of January 11, 1973), which states the following:

"Art.483 – A decision handed down by a foreign court shall not be binding in Brazil, unless and until it is homologated by the Superior Justice Court ("Superior Tribunal de Justiça" or "STJ"). [3]

Sole Paragraph – The homologation process shall abide by the terms of the Internal Regulations of the Superior Justice Court.

Art. 484 – The execution of judgments shall be carried out in accordance with the terms of the certified copy of the judgment."

The homologation process does not entail a "de novo" examination of the merits of the issues leading to the decision handed down by the court of the country of origin of the lawsuit. The granting by the STJ of enforcement authority to foreign judgments entails a preliminary examination, a process known as delibation, to ascertain whether or not the essential procedural requirements for homologation were met by the foreign court of original jurisdiction. Once the foreign decision is homologated by the STJ, it becomes "res judicata," a fact that precludes the handing down of a contrary decision on the same issues in Brazil.

The basic delibation requirements that must be met, in order that a foreign judgment may be complied with in Brazil, are set forth in the Law of Introduction to the Brazilian Statutes (Law n°12376 of 2010), as follows:

"Art.15 – In order that it may be enforced in Brazil, a foreign judgment must meet the following requirements:

a) that it be handed down by a court having jurisdiction [over the matter];
b) that service of process on the parties be properly made, or a default be ascertained;
c) that the foreign decision in question be a final one ("res judicata") and that it meet the formal requirements that apply in the place where it was handed down;
d) that the decision be translated by a qualified interpreter;
e) that it be homologated by the STJ."

With regard to letters-rogatory, a formal statement from the requesting court, to the effect that plaintiff agrees to meet the costs pertaining to the sending of the letter-rogatory, is acceptable to the STJ, which hands down an authorization for the service of process, that is known as "exequatur." Brazil is party to several treaties aimed at expediting the issuance of exequatur decisions, including with the United States and the other member countries in the Organization of American States (OAS), and with the member nations of the Mercosul.

In addition to the delibation criterium, the STJ must ascertain whether or not the foreign decision to be homologated runs counter to requirements pertaining to issues of national sovereignty, public policy and good customs or if it infringes upon any Brazilian statute. Those requirements are collectively known as public order[4] or national sovereignty issues.

Public order matters of a third degree are those that have to do with a number of principles and rules that apply to international relations issues and reflect the interests of the international community.

There are three degrees of public order. The first one encompasses matters pertaining to the country's fundamental legal principles and rules, which include constitutional rights and guarantees, which are not allowed to be waived nor modified by the will of the parties and are collectively known as imperative statutes. The second degree pertains to public international law and encompasses foreign laws and decisions that could clash with internal law provisions.

Public order matters of a third degree are those that have to do with a number of principles and rules that apply to international relations issues and reflect the interests of the international community. In certain instances some such matters may be allowed to prevail over aspects of the internal legal systems in some countries.

It should be kept in mind, moreover, that the concept of public order, which may, and often does, justify a decision to deny homologation to a foreign judgment, is based on a set of fundamental precepts of law, set forth in the Brazilian Constitution, as follows:

1. the preservation of judicial security and its corollary, the protection of legal acts;
2. the obligation of the "Public Power" in a democratic, law abiding society to act with a modicum of good faith and morality;
3. the protection given to the right of property ownership, which prohibits expropriation without due compensation;

4. the guarantee of isonomy and non-discrimination;
5. the guarantee of due process and equality between the parties."

Given these guarantees, it is easy to perceive that a foreign decision that clashes with any of the basic human rights provisions set forth in the Constitution will not be applied in Brazil, because it would be a clear violation of Brazilian public order. Public order concerns justify the denial of homologation requests in a number of cases filed before the STJ, among them being the lack of proper service of process ("exequatur") by means of letters rogatory. Other anomalies include attempts to substitute unacceptable means of service of process, such as through the Registry of Deeds and Titles, and to avoid payment of costs. All such attempts have been struck down by the STJ as being contrary to public order concerns.[5]

Registered Name Case

Among the many references to public order and national sovereignty in STJ homologation procedures, there is a recent one, a rather curious case concerning a New York State Court decision handed down in favor of a plaintiff, born in that state, the son of a Brazilian father and an American mother, who developed ties to both countries and lived and worked in each one at different times and under different names, each name registered with the appropriate agency of each country.

Plaintiff, who opted in 2008 for his U.S.-registered name when he was a resident of Brazil, applied for homologation by the STJ of the New York State Court's decision that ordered that his American name be registered in the U.S. In his pleading before the STJ Plaintiff explained that the dual name situation was detrimental to his civil and economic status and interests by compelling him to have two different names, one registered in Brazil and the other in the United States.

Although the opinion of the Office of the Public Attorney, which had stated that Plaintiff's plea would violate Brazilian public order and national sovereignty concerns, the STJ granted Plaintiff's application for the homologation of the New York State Court's ruling.

As to the nature and scope of the powers of the Office of the Public Attorney mentioned in the "Registered Name Case," they are found in the Federal Constitution, under Articles 127 through 130 and include that of advising the high courts' justices on issues pertaining to the safeguard of civil liberties and social order rights which are set forth in the Federal Constitution.

Jurisdiction of the Brazilian Courts

The section on the jurisdiction of Brazilian courts has to do with the instances where a foreign party needs to file a lawsuit against a Brazilian entity or individual in a Brazilian court and, as such, needs to be acquainted with the restrictions set forth in the Brazilian Code of Civil Procedure. Examples are lawsuits pertaining to real estate located in Brazil and others having to do with probate proceedings involving real estate located in Brazil.

The statutory rules on the external jurisdiction of the Brazilian courts in connection with international disputes are set forth in the Code of Civil Procedure[6] as follows:

The Brazilian judiciary has jurisdiction whenever:

1. defendant, of whatever nationality, is domiciled in Brazil[7];
2. the obligation must be carried out in Brazil;
3. the lawsuit has its origin in a fact that takes place in Brazil or an act performed thereat.

The jurisdiction of the Brazilian courts is an exclusive one in the following instances:

a) whenever the lawsuit pertains to real estate located in Brazil;
b) in connection with probate proceedings and division of assets located in Brazil, irrespective of whether deceased owner of the assets was a foreigner and did not reside in Brazil.

Lawsuits filed abroad are not deemed to be a pending lawsuit ("lis pendens"), nor do they preclude the Brazilian judge from having jurisdiction over the matter at hand and other proceedings related thereto.

Lawsuits pertaining to personal rights and those having to do with property rights over chattels ought to be filed in defendant's place of domicile. In the event that defendant has more than one domicile he/she may be sued at any of them. If the domicile is uncertain or unknown defendant will be sued in the locale where he/she is to be found or in the court of plaintiff's domicile.

In the event defendant is not domicile in Brazil nor a resident thereof the lawsuit will be filed in any jurisdiction.

If there are two or more defendants with different domiciles the lawsuit shall be filed before any of them, according to plaintiff's choice. ❑

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1 For background see our article:"Brazil at the Crossroads: Will the October Presidential Elections Mean the End of the Lula Era?" in the July 2010 issue of LALBR.

2 Article 104, item i.

3 Brazil has a dual high court system that encompasses the Federal Supreme Court ("Supremo Tribunal Federal – STF"), which only hears cases entailing constitutional issues, and the Superior Justice Court ("Superior Tribunal de Justiça – STJ"),

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which is the court of last resort for all other manner of legal issues-including homologation cases, which used to be province of the STF but were switched over to the STJ by Constitutional Amendment nº45 of December 30, 2004.

4 The eminent Brazilian law jurist, Carmen Tibúrcio, a doctor in international law by the University of Virginia and professor of Private International Law at UERJ (State University of Rio de Janeiro), in an article written in collaboration with Professor Luis Roberto Barroso "Public Order and Homologation," describes public order as being "the set of values and political options that are dominant in a given society and at a historical moment, and which are often set forth in the constitutional text, as well as in the current legislation."

The earliest specific statutory reference to the concept of public order is found in Article 17 of the Law of Introduction to the Brazilian Statutes (Decree-Law nº4.657/2010), as follows:

"Art.17 – The laws, acts and sentences of other countries, as well as any statements that express the will of a party, shall have no effect in Brazil if they are offensive to national sovereignty, public order and/ or customs."

5 Art.6 of Resolution 9 of the STJ specifically addresses the issue of public order, as follows: "No foreign judgment shall be recognized nor any letters-rogatory enforced if they run counter to the national sovereignty or to public order."

6 Articles 88 through 94.

7 A foreign entity is deemed to be domiciled in Brazil whenever it maintains an agency or office thereat.

Key Political Risks to Watch in Brazil

By Reuters

President Dilma Rousseff's biggest challenge in the coming months is to engineer a "soft landing" for Brazil's economy and insulate it as much as possible from the burgeoning euro zone debt crisis.

A likely cabinet reshuffle in the New Year will allow her to put her own stamp on the government after scandals brought down six ministers mostly inherited from her predecessor.

Economy Cooling

Compared to many developed countries, Brazil's expected 3.4 percent economic growth this year looks attractive. But after the boom under former President Luiz Inacio Lula da Silva that culminated in last year's dizzying expansion of 7.5 percent, it feels disappointing.

While cheap credit and rising real wages fueled the consumption boom under Lula, real wages have fallen marginally and lending rates are higher since Rousseff took office on Jan. 1. That has fueled discontent in a middle class that forms the cornerstone of her support base. Bank workers and other unions have gone on strike for higher wages to offset inflation, raising the risk of inflation becoming entrenched.

The bankers ended their strike in October after securing a pay rise of 9 percent. A stoppage at Brazil's state-run energy company Petrobras was averted after the company bumped up oil workers' pay and improved conditions.

The government announced measures to shield the economy from the global financial crisis on Dec. 1, including tax cuts on financial transactions, credit, and home appliances and incentives for exporters of industrialized goods. And a recent easing of the inflation rate has allowed the central bank to cut the benchmark interest rate.

What to watch for:

- More industrial action for wage hikes that could pressure inflation.
- Evidence that inflation will continue to slow.
- Additional measures to stoke the economy, boost credit.

President Dilma Rousseff's biggest challenge in the coming months is to engineer a "soft landing" for Brazil's economy and insulate it as much as possible from the burgeoning euro zone debt crisis.

Rousseff, 63, has tried to govern without Congress as much as possible but needs legislators for a series of bills that include reform of an unwieldy tax code, framework legislation for the mining sector and a bill regulating oil royalties, all aimed at easing legal uncertainty and attracting investment.

Other projects on hold include bills aimed at ensuring that Brazil builds stadiums, airports and other infrastructure needed not only for the World Cup and the 2016 Olympics but also to overcome bottlenecks holding back the entire economy. ❏

Mexican Mobile Companies Found Dominant in Call Termination

By Suzanne Rab and Ilyse Stempler (King & Spalding)

Regulators worldwide including in Australia, Japan, the United Kingdom and many European countries have regulated mobile termination rates – the fees that one telecommunications operator charges to another for terminating calls on its network. The basis for this regulation reflects concerns about the relative high level of these charges and resulting high fixed-to-mobile retail prices. In Latin America, despite the expansion in mobile telephony, the relatively high termination charges have come under regulatory scrutiny. According to a recent ruling by the Mexican Federal Competition Commission (CFC), Mexico's three largest mobile phone companies are dominant in the market for terminating calls. This article reviews this ruling from a national, regional and international perspective and what this means for investors in the evolving telecoms markets in Mexico in the near future.

Mobile Termination Charges and Competition

What are Termination Rates?

"Termination rates" may loosely be described as the charges that one telecommunications operator charges to another for terminating calls on its network.

The main charging models internationally are: (i) calling party pays (CPP) in which a subscriber pays only for the calls made and nothing for the calls received; (ii) receiving party pays (RPP) in which the party receiving a communication pays all or most of the end-to-end cost of the communication; and (iii) BAK, also referred to as "net payment zero" (NPZ), being a pricing arrangement where each network agrees to terminate calls from the other network at no charge.

Termination Rates and Competition

Amongst the key issues that have been raised in debates about competition in termination charges are the effect on smaller players and the creation or increase in barriers to market entry.

In Latin America, despite the expansion in mobile telephony, the relatively high termination charges have come under regulatory scrutiny.

In markets where operators have asymmetric market shares, termination rates can result in significant payments from smaller to larger players. An issue is whether this situation can reinforce the network effect of larger networks and increase barriers to smaller operators entering and expanding within markets. For example, it is argued that in order to grow market share in a saturated market, newer entrants have to be able to offer very competitive pricing - not just for on-net calls within their network but also off-net calls to other networks including to fixed lines. According to this view, lower termination rates promote competition in the mobile market, providing customers with more choice. The rationale behind this is that lower termination rates provide scope for operators to offer more pricing and services flexibility so that they are able to increase the range of packages available to consumers.

Regulation of Termination – International Comparisons

Regulators worldwide have focused on termination rates and the issues are not free from controversy.

In the UK, for example, the communications regulator Ofcom announced in March 2011 that it was capping termination rates charged by all four national mobile network operators – 3UK, O2, Everything Everywhere and Vodafone. The regulatory agenda is an aggressive one, seeking a 80 percent reduction in rates over the next four years. All but 3UK are challenging Ofcom's position before the UK Competition Appeal Tribunal.

In the European Union in 2009 the European Commission set out guidance for EU telecoms regulators on a cost-based

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methodology to be used when calculating termination rates. The guidance is in the form of a "Recommendation", of which national regulators are obliged to take "the utmost account". In broad terms, the Recommendation states that termination rates at national level should be based only on the real costs that an efficient operator incurs to establish the connection. However, what constitute relevant costs is an issue of much debate.

In the U.S., providers are generally free to negotiate termination rates provided that they are symmetric/reciprocal. There is no regulatory requirement that such rates be non-discriminatory in the sense that Operator A must charge Operator B the same rate as Operator C for termination on the network of Operator A.

Evolution of the Telecoms Market in Mexico

Regulatory intervention in the telecoms sector must be understood against the evolution of the specific markets.

Any visitor to Mexico will be aware of the economic position held by Mexican telecoms provider Telmex. Telmex was founded in 1947 when a group of Mexican investors bought the Swedish Ericsson Mexican branch. In 1972, the Mexican government took control of the company turning it into a government monopoly. Then in 1990, Telmex was bought by a group of investors formed principally by Carlos Slim, France Télécom, & Southwestern Bell Corporation. In 1991, the Mexican government sold its remaining stock in Telmex. Although Telmex is now a private company, it reportedly still holds somewhere between 75 and 95 percent of all lines of telecoms service.

In January 2010, América Móvil, the largest mobile phone company in Latin America and a sister company to Telmex, made an offer to buy Telmex Internacional. The acquisition was approved by the CFC in February, 2010. This year, América Móvil offered to buy the remaining shares of Telmex that it does not already own. Thus, if the transaction is successfully completed, it will combine the strongest mobile phone company (América Móvil) with the largest land-line network (Telmex) in Mexico under América Móvil.

Mexico has seen considerable development in the mobile and wider communications sector as illustrated by a number of pertinent facts.

- ***CPP:*** Domestically, Mexico introduced CPP in 1999. Following this, the number of mobile subscribers increased dramatically. For long distance calling, before November 2006, mobile users were charged part of the cost to receive long-distance calls, even if they were in their home area. After November 2006, long distance callers to mobile phones were charged the entire cost of the call.
- ***Growth of alternative carriers***: The mobile market owes its origins to the licensing regime in 1989 when the country was divided into nine service regions, each subdivided into an A-band and a B-band. Telcel, then the mobile arm of Telmex and now part of América Móvil, was awarded ten-year B-band concessions in each area. Twenty year A-band licences were sold to Mexico's first alternative operators. Those operators have since consolidated, leaving just two other principal operators — Telefónica Móviles Mexico (TMM, or Movistar) and Iusacell (including Unefon).

Regulatory intervention in the telecoms sector must be understood against the evolution of the specific markets.

- ***Digital:*** The entry of the digital operator Nextel de México has been contentious. Nextel was the first operator licensed for push-to- talk (PTT) services in Mexico, and it launched wireless PTT services over an iDEN network in August 1998.
- ***Triple play:*** "Triple play" service refers to the provision of two bandwidth-intensive services, high-speed Internet access and television, and a less bandwidth-demanding (but more latency-sensitive) service, telephony, over a single broadband connection. In the early 2000s, due to regulatory constraints, voice and cable operators could not offer a traditional triple play, and had to form strategic partnerships with each other to bring a hybrid triple play offering to market. Mexico's first triple play service, combining cable TV, Internet, and telephony, was launched in March 2005 by fixed-line provider Maxcom and local cable TV operator SIT. In 2006, the Secretaría de Comunicaciones y Transportes (SCT) gave final approval for a "triple play" plan to permit telephone companies to enter the television market and for cable and other media firms to sell telephone services. Yet, despite allowing for triple play generally, Telmex has thus far not operated in the TV sector. Regulators have demanded that Telmex's network be fully open to interconnection and interoperability with competitors as a pre-condition for allowing it to offer triple play services.

Mexico Puts the Competition Spotlight on Telecoms

Dominance in Mobile Termination

Against the evolving telecoms market backdrop in Mexico, the CFC has found that América Móvil (through Telcel), Telefónica and Grupo Salinas (Iusacell and Unefon) together hold more than 95 percent of Mexico's mobile phone contracts. It has also found that each company has "significant power" in the mobile termination market.

A consequence of this ruling is that it provides a basis for Mexico's Federal Telecommunications Commission (Cofetel) to regulate mobile termination rates. The mobile operators are expected to maintain a challenge to the CFC's decision. If the ruling is overturned, it is assumed that Cofetel will not have a legal basis to regulate the companies' termination rates on account of significant market power.

Other Recent Regulatory and Competition Law Interventions in the Mexican Telecoms Sector

The ruling of the CFC in relation to termination rates is the latest of a series of attempts by Cofetel and CFC to confront what they see as excessive power or anticompetitive practices in the telecoms sector in Mexico.

Cofetel has tried many times to rein in Telmex, with limited apparent success. The Office of the U.S. Trade Representative pressed more successfully, and in 2004 received a favourable World Trade Organisation ruling on the openness of the Mexican telecoms market; this set the stage for a reduction of interconnection rates. This ruling also prompted some strengthening of Cofetel's powers and a number of agreements on reducing Telmex's interconnection rates.

There are signs that Cofetel is beginning to take a firmer line against Telmex. In July 2009, it ruled that Telmex is dominant in the fixed-line sector and, although Cofetel opted not to fine the company, it supported asymmetrical regulation to encourage competition.

In an attempt to boost competition, Cofetel set a spectrum cap of 80 mhz on existing operators wishing to compete in a mobile frequency auction. The resolution is expected to boost competition since the frequency bands can deliver applications that require large speeds of data transmission such as video on demand in HD or VoIP.

In mid-April 2011, CFC issued the largest fine for monopolistic behaviour in Mexico's history. It imposed a USD1 billion penalty on Telcel, a subsidiary of América Móvil, for high interconnection fees. The fine marked the second antitrust sanction against Telcel.

In early September 2011, having been required to review findings that América Móvil's local fixed-line and wireless units – Telmex and Telcel – were dominant in their respective sectors, CFC reiterated a previous ruling that Telmex was indeed dominant in the market for the completion of calls to fixed lines, revealing that commissioners had voted unanimously to uphold the decision.

Key Issues Going Forward

Competition and Economic Issues

The competition issues around regulation of mobile markets are not clear-cut. Proponents of tighter reform in Mexico maintain that strategic investors could be put off entering the market because of the local strength of América Móvil. It is maintained that Telmex's dominance, as found by the CFC, has resulted in a lack of investment in infrastructure and new technology, and relatively low teledensity. Mexico has one of the highest phone charges and lowest teledensities within the OECD region. Furthermore, it has been argued that Telmex has no incentive to invest in new links, causing congestion and quality of service problems. Although there are three operators in the mobile market, according to CFC and supporters of reform, Telcel's lead is hindering competition with relatively high tariffs and alleged anticompetitive practices.

The competition issues around regulation of mobile markets are not clear-cut. Proponents of tighter reform in Mexico maintain that strategic investors could be put off entering the market because of the local strength of América Móvil.

Legal and Institutional Issues

Even where an authority has evidence in support of intervention and a genuine will to take a tough line, legal and institutional issues may present hurdles.

- ***Entrenchment of officials and decision-making:*** It can be difficult to remove officials from office in order to prevent political or interest groups from influencing the competition body. In Mexico, members of the CFC can be removed only for well-founded causes. However, it is unclear to what extent the remedy of recusal - where an official is required to or does in fact step down from a decision-making role on account of a risk of a conflict of interest - will have a meaningful impact in concrete cases. Fines issued by the CFC can be appealed to a five-member body. For example, América Móvil appealed its USD 1 billion fine. Although initially the fine was approved, the commissioners voted to recuse the agency president on account of his statements to the press on the case. The outcome of this case is awaited.
- ***Collateral attacks on CFC decisions:*** Citizens can challenge any authority's action in court that is considered to be unconstitutional. Right of action, amparo, is broad and has been used to challenge all aspects of CFC decisions, agency procedures, and determinations. Corporations and individuals have used amparo as a litigation tactic to delay or avoid enforcement of CFC resolutions. A balance needs to be struck by ensuring that affected parties may challenge an initial decision of the CFC and that the latter is held accountable - and also in ensuring that there is sufficient confidence in the CFC's primary decision-making.
- ***Judicial experience and expertise:*** Many judges do not have the expertise to fully appraise the economic issues

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presented in competition cases. However, as a step in the reform agenda, it is expected that judges and courts will be established with specialist expertise to review CFC decisions. While the timing of this development is unclear, such a move would be welcome resembling the practice in the UK, Australia, Canada and Denmark

- ***Relationship with sectoral authorities:*** CFC can issue opinions and recommendations regarding the effects on competition of proposed and existing law, but they are not binding and may even be ignored by sectoral authorities. A clearer articulation of the policy behind and guidance on the respective roles of CFC and Cofetal would be useful in terms of the transparency and clarity of decision-making.
- ***Limited resources:*** Despite an increased budget, CFC is still among smallest competition agencies worldwide relative to the size of the Mexican economy. There is an ongoing effort to increase resources.
- ***Competition culture:*** It may be trite to say that one of the chief barriers to effective implementation of competition law is the lack of a developed competition law culture. Despite having some form of competition law at least since 1993, Mexico still faces challenges in cultivating an environment where the positive role of competition law is ingrained in doing business. Advocacy by the regulator can help but businesses themselves have a role to play in promoting a culture of compliance.

Social Issues

It may be argued that the current charging system has coincided with greater social inclusion in the Mexican telecoms markets. The proportion of prepaid customers is relatively high, resulting in Mexico having one of the lowest levels of revenue per user in Latin America. Urban areas are largely saturated. Turning their focus to remoter communities involves more expenditures for operators, which makes lowering prices more difficult.

According to Cofetel data, mobile penetration has risen from 29 per 100 population in 2003 to 80 per 100 in mid-2010. The number of fixed lines has remained stagnant in recent years at around 19.5 million from 2005 to mid-2010, representing a slight drop in density from 18.7 per 100 population to 18 per 100 during the same period (Economist Intelligence Unit, Mexico: Telecoms and Technology Report, October 2010).

Political Issues

A striking feature of communications markets, and mobile in particular, is their propensity to arouse strong consumer interests and emotions. When these coincide with powerful commercial interests and personalities, the regulator faces an uphill struggle in trying to maintain independence and rigour, while not giving in to popular pressure. A few examples of the challenges experienced by CFC in trying to maintain such independence serve to illustrate this tension.

In mid-April 2011 and as noted above, CFC issued the largest fine for monopolistic behaviour against Telcel/ América Móvil. In June, the CFC recused its chairman from the case. CFC approved the fine with a 2-2 tie because the agency's president approved the fine and his vote counted twice in the case of deadlock. América Móvil has argued that Eduardo Pérez Motta, the agency president, should also be recused because of comments he made to the press that revealed apparent bias. After a vote, Eduardo Pérez Motta, was recused; leaving only three commissioners, two of whom voted against the fine. In September, President Calderon replaced one of the recused members, whose term was complete, with Cristina Massa Sánchez, an attorney familiar with competition law and involved in the recent reforms. He will be able to vote on appeal of the fine which is still pending.

Meanwhile, the public prosecutor's office launched a criminal investigation in October 2011 into Héctor Osuna, former vice-president of the telecoms regulator Cofetel, and his colleagues. Investigators suspect that Cofetel executives engaged in "back door" manoeuvering to grant Telmex (owned by Carlos Slim) access to the TV market on allegedly unfair grounds.

Conclusion

Recent regulatory and competition law intervention in Mexican telecoms cases reveals challenges and tensions that are not new to the sector internationally but which are infused with local market idiosyncrasies. If the CFC's 2011 ruling that the three principal Mexican mobile operators enjoy a position of dominance in mobile termination stands, then the telecoms regulator will be able to regulate termination fees. Such a decision takes place in a highly charged environment. Put simply, a tangible product such as a communication device that most people want to buy can arouse strong emotions which may frustrate commercial practices irrespective of the economic and intellectual merits.

The competition and economic issues, while intuitive in principle, always have at least two sides to the story. The advances that have been made in mobile have brought significant consumer benefits, whilst rivals to the largest operators raise arguments of foreclosure. The companies will need to work through the economic arguments against intervention and assemble the evidence needed to support their case, if they are to convince the sector and competition decision-makers that what is good for commercial reasons is also good for the consumer. Companies and regulators can take some guidance on how similar cases have been dealt with elsewhere, tempered with the recognition that sensitivity is required to the different socio-economic and political considerations that are in play in Mexico. ❏

Mexican M&A Overview

By Mergermarket

M&A activity in Mexico in the first three quarters of 2011 stood at 35 deals valued at US$ 6.5bn, which represented an 87% decrease by deal value compared to the same period last year (36 deals worth US$ 49bn). However, last year was an exception: the Telecommunications sector, which so far in the year to date had only one undisclosed transaction, ended up being the most active sector in Q1-Q3 2010 (3 transactions valued at US$ 36bn). The two of the three Telecommunications deals last years included America Movil's acquisition of Carso Global and Telmex International for a total deal value of US$ 34.5bn announced on 13 January 2010. The Telecommunications sector was also very active in 2006, when America Movil announced its acquisition of America Telecom for US$ 31.7bn.

The Consumer sector is the dominant sector so far this year. The largest deal in Mexico in the first three quarters of 2011 was in the Consumer sector: Embotelladoras Arca acquired Grupo Continental for US$ 2bn. The second largest deal was Grupo Mexico's acquisition of Grupo Aeroportuario for US$ 1.4bn in the Transportation sector.

In Q1-Q3 2011, the Consumer sector represented 64.4% of the total M&A activity in the country by deal value and 34% by deal count (12 deals valued at US$ 4.2bn). Transportation had a market share of 25.1% by deal value and a market share of only 5.7% by the number of deals. The Financial Services sector (5 deals worth US$ 200m) accounted for 14.3% of the total deal count in Mexico but only 3.1% of the total deal value. ❑

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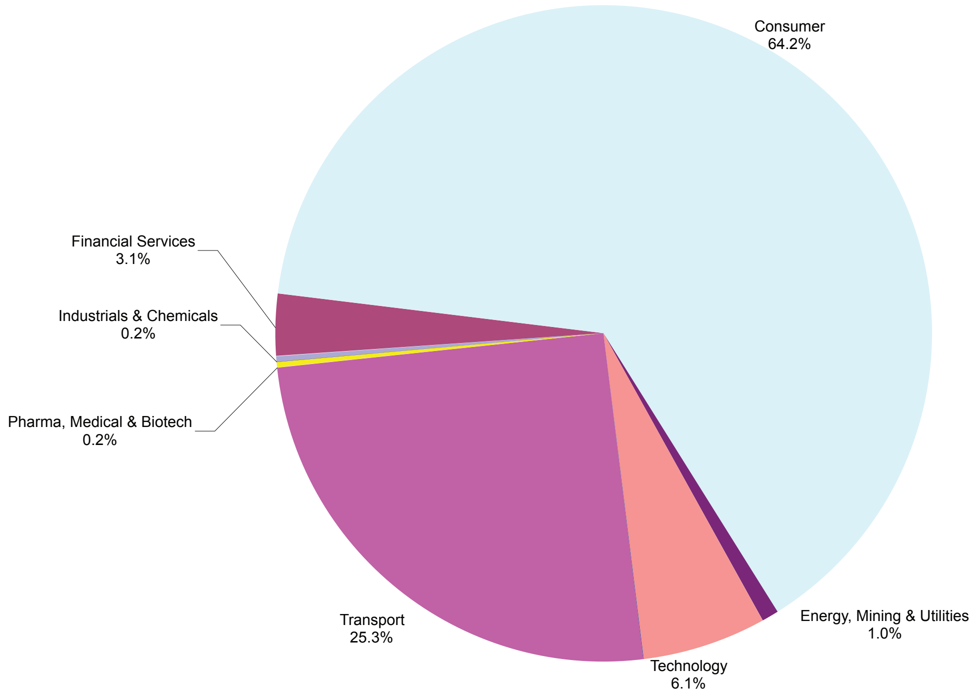
Mexican M&A Sector Breakdown Q1-Q3 2011—Deal Value



Mexico: The "Sleeper" in Latin America's PE Industry

By Alyson Sheehan (Thomson Reuters)

(EDITOR's NOTE: *Venture Equity Latin America (VELA)*, also published by Thomson Reuters/WorldTrade Executive, recently released its 2011 Mid-Year Report. This article is an excerpt from the Report. For information on how to order the Report contact Jay Stanley (978) 287-0391 or Jay.Stanley@Thomsonreuters.com.)

Upsides to Investment in Mexico

Experts in the private equity and venture capital industry consistently stated in the first half of 2011 that Mexico is poised for increased private equity investment in the foreseeable future. Jose Contreras of Wamex Private Equity ("Wamex"), based in Mexico City, told *VELA* in February that there were ample reasons for investors and entrepreneurs to be excited about Mexico. With the economy positioned to grow 4 to 5 percent in 2011, "all the macro variables are in place," Contreras said at the time, referring to "inflation, the exchange rate, interest rates, [and] government policy."[1]

The emergence and continued growth of a middle class in Mexico also helps to precipitate increased private equity investment, as investors take advantage of consumers' growing demand for products and services coupled with local businesses' need for financing. Pilar Aguilar, managing director of Endeavor Mexico, told *VELA* in May that Mexican families average about 1.8 children per household, according to census data, and that the number of women who work has increased significantly. A growing number of two-income households leads to a growing amount of disposable income.[2]

In addition, the Mexican pension funds, known as the Afores, have become substantial players in Mexico's local private equity industry, helping to galvanize local pools of capital available for investment. Mexico's pension funds are permitted to devote approximately $11 billion to the alternative assets class, according to Alexander Rossi of Mexico-based private equity fund manager Latin Idea Ventures, and within the past year they have already invested about $2 billion in Mexican private equity, real estate and infrastructure.[3] Mexican institutional investors, including the Afores, can also invest in initial public offerings (IPOs), which should help to grow the number of IPOs in Mexico.

Finally, competition for investment opportunities in Mexico is milder than in some neighboring Latin countries. So, many strong companies come at a better price. Joaquin Avila of private equity fund EMX Capital expressed to *VELA* in April that "in terms of entry valuations, Mexico is cheaper" than other emerging market economies like Brazil or China.[4] These reasons and more may explain why Matt Cole of North Bay Equity Partners suggested to *VELA* in May that, "Mexico is perhaps the sleeper in the Latin American private equity market."[5]

Mid-Year 2011: Ambiguous Turnout

There were seven investments recorded in Mexico in the first half of 2011. It is difficult to gauge a total investment level for the country in the first half of the year, as only local venture capital fund IGNIA Partner's investment – worth $2.4 million – in clean water provider Distribuidora Mexicana Aqua Purificada en Red is quantifiable. Nonetheless, Mexico saw eight investments in mid-year 2010, six of which were disclosed and amounted to $165 million, and five investments in mid-year 2009, three of which were disclosed and amounted to $38 million. Based simply on the number of deals carried out in 2011, it would appear that activity amongst private equity investors for Mexican assets dropped off slightly since mid-year 2010, though it's impossible to verify, based on the financial data available, whether the total amount of equity capital injected into the country actually shrank, grew or stayed the same year-over-year.

Of the seven investments that took place in the first half of 2011, four were private equity investments, one was a venture capital investment, and one was a growth equity investment. Popular sectors for investment were food production and distribution (including IGNIA's investment in a clean water distributor) and consumer products and retail. There were also investments made in transportation and fuel production and distribution. Much like last year, investors targeted businesses and industries that cater to consumers, as a burgeoning middle class continues to expend their new disposable incomes. For instance, food production and distribution was an industry positively impacted by the growth of the middle class 12 months ago, with investments in food accounting for 25% of total deals recorded in the *VELA 2010 Mid-year Report*.[6] In mid-year 2011, the percentage of food investments in Mexico rose significantly, accounting for 43% of total deals recorded.

Consumer products and retail accounted for 29% of Mexico's recorded private equity investments in the first half of 2011, serving as an another testament to investors' keen interest in middle class consumption. In January, Evercore Mexico Capital Partners, the private equity division of Protego, acquired a 20% stake in Grupo Axo, a brand management company in the Mexican retail and fashion industries, according to Thomson Reuters' peHUB. The deal was made through Evercore Mexico Capital Partners II. Then in April, Latin American asset manager Linzor Capital ("Linzor") acquired a controlling stake in Colsa, a Mexican eyewear chain with over 160 outlets, which was the first investment made through Linzor's second fund, according to the Emerging Markets Private Equity Association (EMPEA).

Other investments in the first half of 2011 include Alta Growth Capital's growth equity investment in marine oil distributor Bunker's Group, and Mexican private equity firm

PC Capital's acquisition of Nuevo Grupo Aeronautico, the holding company of bankrupt airline, Compania Mexicana de Aviacion.

Obstacles to Investment in Mexico

A thread of perceived limitations within Mexico's private equity industry peppered *VELA's* interviews with investors over the course of this half-year. The most commonly mentioned problem is the incidence of drug-related violence in Mexico, as its troublesome presence may play a substantial role in driving investors away. Contreras of Wamex acknowledged the country's drug violence in his February interview: "The reality is bad, and it's something that has to be improved," he said at the time. However, Contreras argued: "It's just a few cities where the violence is bad, and the government has done a lot in taking out top leaders of the cartel, so overall drug organizations are weaker. It's a long hard fight that can be won just like Colombia did."[7]

So, the perception of Mexico's drug violence may be exaggerated – but perception alone may be enough to deter investors. Roberto Terrazas of Nexxus Capital ("Nexxus"), a Mexican private equity fund manager that made two substantial investments in the first half of 2011, lamented the country's "poor job of marketing" in a February interview with *VELA*.[8]

"Pretty much all you hear outside Mexico is about drug traffic and security," Terrazas said. "We do have problems, but not close to what's presented in the media. We continue to do business as usual."[9]

To that end, Nexxus Capital made two investments in Taco Holding, a Mexican company that owns and operates fast food restaurants, in 2011. In March, Nexxus acquired Arrachera House and Sixties Burger through Taco Holding via Nexxus Funds IV and V. Arrachera House owns a restaurant chain providing fast food services in more than 40 units in Mexico; Sixties Burger owns more than 30 units across the country as well. Then in May, Nexxus made an additional investment in Taco Holding to acquire Krispy Kreme Mexico, which has the master franchise for Mexico and operates over 60 units in the country, according to EMPEA.

Another challenge to Mexico's private equity environment is its dependence on the U.S. economy, which in recent months has caused some investors to shy away from the country, according to *VELA*.[10] This was also a problem acknowledged in the *VELA 2009 Mid-Year Report*, which noted that Mexico was really "feeling the pain" of the global financial crisis that began in fall 2008.[11] However, some investors such as Scott Swensen of New York-based Conduit Capital ("Conduit") argue that while Mexico's economy did contract in 2009, it has since rebounded in 2011.[12] Conduit's investments in Mexico include two hydroelectric projects worth $80 million, one of the largest disclosed investments of 2010, according to *VELA* data.[13]

Deal Monitor: Mexico

Investor	Portfolio Co.	Fund	Amt.*	Stake	Country	Industry	Type	Co-Investors	Date
Alta Growth Capital	Bunker's Group				Mexico	Fuel production/distribution (marine oil distributor)	Growth		May 2011
Evercore Mexico Capital Partners, PE division of Protego	Grupo Axo	Mexico Capital Partners II		20%	Mexico	Retail (brand management company)	PE		January 2011
IGNIA Partners	Distribuidora Mexicana Aqua Purificada en Red	IGNIA Fund I	$2.4		Mexico	Clean, purified water	VC		May 2011
Linzor Capital	Colsa	Linzor Fund II			Mexico	Consumer products (eyewear chain)	PE		April 2011
Nexxus Capital	Taco Holding (Krispy Kreme Mexico)	Nexxus Funds IV, V			Mexico	Food production/distribution	PE		May 2011
Nexxus Capital	Taco Holding (Arrachera House, Sixties Burger)	Nexxus Funds IV, V			Mexico	Food production/distribution	PE		March 2011
PC Capital	Nuevo Grupo Aeronautico				Mexico	Transportation (airline)	PE		February 2011
$2.4 Million Invested (via 7 acquisitions -- 1 disclosed in 1H2011)									

*Amounts in millions U.S. $

The "Sleeper", Continued on page 26

The "Sleeper" (from page 25)

A third snag to Mexico's private equity industry is its political cycles, which makes investors nervous because of its potential ties to the economy, according to Contreras of Wamex. Therefore, the election for president next year may impact Mexico's investment levels in 2012.

Mexico's Fundraising, Exits

The 2011 mid-year data shows that Mexico's fundraising environment is difficult, and investors who spoke to *VELA* in the first half of 2011 tend to agree. Relating back to Mexico's poor job of marketing the country to foreign investors, Terrazas of Nexxus Capital said that from a fundraising perspective, he was "very pessimistic."[14] Rossi of Latin Idea Ventures expressed a similar sentiment in April, explaining that the process of reaching investors may be easier now, thanks to a greater wherewithal of the industry on the part of Mexican investors, but that "it doesn't mean it's easier to get money out of them. In some ways it's harder because there's more competition – more funds."[15]

There were five Mexico-focused funds with closings in the first half of 2011, four of which are devoted solely to Mexico and one of which is concentrated on both Mexico and Brazil. Together the funds raised a total of $532 million in capital commitments, accounting for 7.1% of total fundraising activity in the first half of 2011. For comparison's sake, Mexico secured $615 million in capital commitments in mid-year 2010 and $450 million in mid-year 2009.[16]

Nexxus Capital held the final closing of its fifth fund, Nexxus Fund V, in the spring of 2011, which is being deployed in tandem with the private equity fund manager's fourth fund, Nexxus Fund IV, a Mexican certificados de capital de desarollo (CKD) trust that had its final close in October 2010, according to Nexxus's website. Together, the two funds raised a combined total of $315 million, the largest disclosed fund in the country for the first half of the year. As previously mentioned, Nexxus has already twice deployed capital in the food production and distribution sector in Mexico this year. Notably, the Mexican pension funds, the Afores, committed capital to Nexxus's fundraising efforts.

EMX Capital held the final close of its first fund, EMX Capital I, in March and completed the offering, which was executed on the Mexican Stock Exchange, for approximately $127 million, according to EMPEA.

In addition, Latin American-focused investment management firm Alsis Funds held the first closing of its Alsis Mexico Opportunities Fund, which received capital from the California Public Employees Retirement System (CalPERS), according to Alsis Funds' website; Wamex Private Equity held the second close of its Multinational Industrial Fund II with $90 million in capital commitments; and former Spanish Prime Minister Felipe Gonzalez created an investment fund called Tague Capital to invest in companies in Brazil, Mexico and Spain with an emphasis on sectors including life sciences, clean energy and information technology, according to EMPEA. While there were not any recorded private equity investments in clean energy in the first half of 2011, it is a sector that should bode well for the country in the future, as Mexico is the third country in the world in terms of geothermal power capacity and one of the most sought after places for wind energy generation, according to *VELA*.[17]

As for exit activity in Mexico for the first half of 2011, recorded disbursements were minimal, though more substantial than in mid-year 2010, when only one exit was recorded.[18] Now in mid-year 2011, two exits have been recorded in the country. As previously mentioned, Mexican private equity firm PC Capital acquired a 95% interest in bankrupt airline Nuevo Grupo Aeronautico; this transaction represents a sale for Tenedora K, a Mexican consortium of Grupo Industrial Omega, Grupo Arizan, the pilots union and others, who traded the stake to PC Capital for an undisclosed value.

Additionally, Wamex Private Equity divested a minority stake in manufacturing company Epiq MX, the fifth exit from its Multinational Industrial Fund I. Epiq MX, which specializes in electronic assembly and plastic injection molding for automotive original equipment manufacturers, is the Mexican subsidiary of Belgium-based Epiq Group, according to the private equity fund manager's press release. The value of the transaction was not disclosed. Wamex is attracted to the auto parts industry in Mexico because of the country's proximity to the U.S. as compared to China. Contreras believes that the U.S. is shifting manufacturing to Mexico, according to *VELA*.[19] It is conceivable that Mexico may become a leader in the auto parts industry on an international scale. ❑

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Venezuela - New Law on Fair Costs and Prices (Price Controls)

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A Decree with status of Law on Fair Costs and Prices (hereinafter "LCYPJ" as per its Spanish Acronym) was published in July 2011 in the official Gazette N° 39.715. This Law will enter into effect after 90 business days from the publication date. The objective of this Law is to establish and regulate prices on goods and services in the local market.

The purpose and goals of this Decree-Law will be materialized in the National System of Costs and Prices constituted by the National Superintendence of Costs and Prices (hereinafter the "SUNACOPRE" as per its Spanish Acronym). SUNACOPRE shall establish the standards for the National Registry of Prices of Goods and Services, and will have overall responsibility to regulate, supervise, control, and monitor prices, and it will also have the authority to establish Maximum Retail Prices (PMVP) or the price range for goods and services, among other activities.

This Law is applicable to all individuals, and corporations (either public and private; national or foreign) which produce, import or trade goods or services within the national territory. Financial institutions are excluded from this regulation.

For the determination of the fair price of goods and services, SUNACOPRE will base its decision mostly on the

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Adjustments in the Price	Adjustments to Costs
Should SUNACOPRE determine a new price for a given product or service for not considered it "fair", the level of the local entity's profitability may decrease. Thus, potential transfer pricing adjustment might occur due to lower profitability at the local level.	If the cost structure of the product or service is adjusted (assuming that SUNACOPRE considers that such cost structure is high for that product or service), transfer prices would be affected.

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information provided by the parties previously indicated, which should be consistent with their structure of direct and indirect costs, as well as general, administrative, distribution and sale expenses when applicable, and the expected profit based on the expectations and risks undertaken.

Relation of the Law on Fair Costs and Prices with Transfer Pricing

All those companies which carry out transactions with foreign related parties should evaluate their cost and pricing structure, given that this regulation may affect them directly. For instance, depending on the type of adjustment that SUNACOPRE may apply by virtue of the powers granted thereto, the following scenarios may emerge:

Based on this new regulation and potential requirements, detailed documentation on the cost structure for products and services as well as the support of the terms of operation established by the parties subject to this law are highly recommended. Thus, a detailed analysis on segmented financial information, as well as the documentation of functions, assets and risks will become relevant as part of the elements of documentation and analysis of the information which is to be provided, under the standard relating to Fair Costs and Prices and in the case of eventual requirements of SUNACOPRE. ❏

Based on this new regulation and potential requirements, detailed documentation on the cost structure for products and services as well as the support of the terms of operation established by the parties subject to this law are highly recommended.